91-642

No. 91-____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

HOWARD GILMAN,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED

1. Whether the court of appeals below erred in affirming the imposition of penalties under section 6659 of the Internal Revenue Code based on an interpretation of section 6659 which the court admitted was "odd" and "strained," which directly conflicts with decisions of the Court of Appeals for the Fifth Circuit and which is at odds with a decision of this Court.

2. Whether the court of appeals below erred in requiring a taxpayer to establish in a speculative transaction a "reasonable possibility of profit" as a prerequisite for the transaction to be respected for tax purposes, a requirement in direct conflict with two recent decisions by the Court of Appeals for the Sixth Circuit.

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Petitioner, Howard Gilman, prays that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Second Circuit affirming a judgment of the United States Tax Court.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit is reported at 933 F.2d 143 (2d Cir. 1991) and is set forth in the Appendix at pages 1a-20a. The initial memorandum opinion of the Tax Court is unofficially reported at 58 T.C.M. (CCH) 1075 (1989) and is set forth in the Appendix at pages 22a-44a. The supplemental memorandum decision of the Tax Court, which was issued pursuant to Petitioner's Motion to Vacate or Revise, is unofficially

reported at 59 T.C.M. (CCH) 465 (1990) and is set forth in the Appendix at pages 45a-48a.

JURISDICTION

The decision of the Court of Appeals below was entered on May 14, 1991 (Appendix at 1a). On July 16, 1991, the United States Court of Appeals for the Second Circuit denied a timely petition for rehearing (Appendix at 53a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

Section 6659(a) through (c)(1) of the Internal Revenue Code:

(a) ADDITION TO THE TAX.—If—

(1) an individual, or

(2) a closely held corporation or a personal service corporation,

has an underpayment of the tax imposed by chapter 1 for the taxable year which is attributable to a valuation overstatement, then there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributable.

(b) APPLICABLE PERCENTAGE DEFINED.—For purposes of subsection (a), the applicable percentage shall be determined under the following table:

If the valuation claimed is the following percent of the correct valuation—	**The applicable percentage is:**
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

(c) VALUATION OVERSTATEMENT DEFINED.—

(1) In General.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

Section 183(a) through (c) of the Internal Revenue Code:

(a) GENERAL RULE.—In the case of an activity engaged in by an individual or an electing small business corporation (as defined in section 1371(b)), if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) DEDUCTIONS ALLOWABLE.—In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—

> (1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and
>
> (2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) ACTIVITY NOT ENGAGED IN FOR PROFIT DEFINED.—For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

Treasury Regulation § 1.183-2. Activity not engaged in for profit defined. Set forth in the Appendix at pages 56a-63a.

PRELIMINARY STATEMENT

Point I: Section 6659 Overvaluation Penalty.

The taxpayer Howard Gilman purchased computer equipment in 1980 at a price equal to its value of $3 million. A contemporaneous appraisal of the computer equipment supported that value. Nevertheless, the Commissioner of Internal Revenue (the "Commissioner") asserted that the taxpayer was liable for the valuation overstatement penalty under section 6659 of the Internal Revenue Code[1] based on an overvaluation equal to the entire $3 million purchase price on the theory that the purchase was a "sham," and therefore the taxpayer's basis in the computer equipment was zero. The Tax Court upheld this result despite the fact that it did not find that the equipment was worth any less than $3 million when Gilman bought it. The Court of Appeals for the Second Circuit acknowledged that this construction of section 6659 was "strained" and "odd." But it affirmed the Tax Court nonetheless.

The application of the penalty provision of section 6659 in this situation, where the tax deficiency is not related to an overvaluation of the equipment, is contrary to the result reached on similar facts in the Fifth Circuit. The decision of the court of appeals upholding the application of the penalty statute in this case also conflicts with a decision of this Court that require that penalty statutes be strictly construed.

Point II: The Requisite Profit Potential.

There are now pending across the nation numerous cases in which the Commissioner is asserting that taxpayers entered into speculative transactions which the Commissioner believes (1) did not have a "reasonable possibility" of profit and (2) that the taxpayer did not have a sufficient "profit motive"

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1 All "section" references are to the Internal Revenue Code of 1954, 26 U.S.C. § 1 *et seq.* (the "Code"), as amended and in effect for the years at issue, and all "regulation" references are to the Treasury regulations promulgated thereunder.

for the benefits to be allowed. The legal standards being applied by the courts in these cases are fundamentally inconsistent. As a result, similarly situated taxpayers are being treated differently. It is of the utmost importance to taxpayers that the legal standards be fair, reasonable and consistent.

There is currently a conflict among the circuits as to what probability of profit is required, and the correct criteria to apply to determine a taxpayer's business purpose/profit motive, in order for a transaction to be respected for income tax purposes and not be disregarded as a "sham." The Court of Appeals for the Second Circuit, along with several other circuits, has required that a "reasonable possibility" of profit exist. This holding is incorrect in light of section 183. The Sixth Circuit Court of Appeals, in contrast, has held that under section 183 and the regulations thereunder, a speculative transaction need not have a "reasonable possibility" of profit and that a business purpose/profit motive can be evidenced by a small chance of making a large profit. This conflict between the circuits as to the proper legal standards to apply compromises the fairness of the tax laws. It also stifles bona fide investment in speculative and high-risk endeavors which Congress sought to motivate with statutory tax benefits.

STATEMENT OF FACTS

In 1980, Gilman bought computer equipment (the "Equipment") from an unrelated seller for $3 million. In buying the Equipment, he invested approximately $470,000 of his own cash and issued promissory notes, more than $2.3 million of which he was personally liable to repay. Gilman leased the Equipment to an unrelated lessee for a nine year term ending in 1989 (the "Lease"). The Equipment and all of its rental income provided security for Gilman's promissory notes. The rental income was expected to pay off his promissory notes by the end of 1989. In addition, Gilman would have excess cash flow (rent in excess of his debt service) of approximately $76,000 over the term of the Lease. At the end of the Lease,

Gilman's unrecovered cash investment in the Equipment would be approximately $394,000. If the Equipment had a residual value in 1989 of at least $438,000 (14.6% of Gilman's cost), Gilman would make a profit on his $394,000 net cash investment after paying a 10% equipment marketing fee. If the Equipment's residual value was more, his profit would be higher. If it was less, he would sustain a loss.[2]

Contemporaneous with his purchase of the Equipment, Gilman received an appraisal from Diebold, Inc. ("Diebold"), a well-respected New York Stock Exchange listed computer consulting company with branch offices throughout the world. Diebold estimated that the residual value of the Equipment would be at least $600,000. Thus, at a minimum, Diebold estimated that Gilman's cash profit would be more than $146,000.[3]

On his 1980 and 1981 tax returns, Gilman deducted depreciation with respect to the Equipment based upon his $3 million cost and deducted interest on the indebtedness he incurred to buy the Equipment. He also included as income the rent he received under the Lease. The Commissioner disallowed those tax deductions and ignored Gilman's rental income, thereby producing tax deficiencies. The Commissioner classified Gilman's 1981 tax deficiency as being attributable to a "valuation overstatement" of the Equipment and

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2 A sale of the Equipment in 1989 for $438,000 (14.6% of original cost) would yield Gilman $394,200 after payment of a 10% remarketing fee, thereby exceeding his $394,000 unrecovered cash investment at that time.

3 A $600,000 residual value would produce $540,000 of net proceeds for Gilman (after a 10% marketing fee), $146,000 above Gilman's $394,000 unrecovered cash investment at that time.

Diebold also opined that: (1) the $3 million purchase price Gilman paid for the Equipment was its then fair market value; (2) the Equipment would have a useful life extending at least 2½ years beyond the end of the Lease; and (3) the rental payments Gilman would receive for the Equipment represented a fair market value rental during the Lease.

imposed a tax penalty under section 6659.[4] The Commissioner also treated both years' tax deficiencies as resulting from a tax-motivated transaction and imposed a penalty rate of interest to Gilman's tax deficiencies under section 6621(c).

At trial the Tax Court disregarded the entire transaction as a "sham," holding that (1) the transaction lacked "economic substance" and (2) Gilman lacked a business purpose or profit motive for entering into the transaction. The Tax Court's holding was based on its conclusion that there was no "reasonable possibility" that the Equipment's residual value would be sufficient for Gilman to recover his cash investment.

The Tax Court held that Gilman's tax basis in the Equipment was reduced to zero from his $3 million purchase price because the transaction was disregarded as a sham. This holding literally produced a valuation overstatement for purposes of section 6659 that was infinite.[5] The Tax Court further held that Gilman's 1981 underpayment was attributable to this valuation overstatement and imposed the maximum penalty under section 6659, which scales the penalty to the percentage of valuation overstatement, because the valuation overstatement was more than 250 percent. The Tax Court also imposed the penalty rate of interest under section 6621(c), based on its holding that the underpayment was attributable to a valuation overstatement.

The Court of Appeals for the Second Circuit affirmed the decision of the Tax Court.

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4 The Commissioner did not assess the section 6659 tax penalty against Gilman for 1980 because that penalty was effective only for tax returns filed after December 31, 1981.

5 The statutory calculation of the valuation overstatement uses a fraction the numerator of which is the basis claimed on the return and the denominator of which is the correct basis. If the correct basis is deemed to be zero, the valuation overstatement is necessarily infinite.

REASONS FOR GRANTING THE WRIT

POINT I.

The Court of Appeals Below Erred in Affirming the Imposition of a Tax Penalty Under Section 6659 Based on an Interpretation Which It Admitted Was "Strained" and "Odd" and Which Is at Odds with Decisions of the Court of Appeals for the Fifth Circuit and with a Decision of This Court.

The Court of Appeals for the Second Circuit upheld the imposition of a penalty on Gilman for "overvaluing" his tax basis in the Equipment. It did so based on what the court admitted was a "strained" and "odd" interpretation of section 6659. The penalty was imposed on Gilman even though his legal ownership of the Equipment was undisputed and there was no finding that the value of the Equipment was less than his $3 million cost. It was imposed because Gilman's $3 million basis was treated as having been reduced to zero since his purchase of the Equipment was disregarded as a "sham." The court's interpretation conflicts with decisions of the Court of Appeals for the Fifth Circuit and with a decision of this Court.

A. Treating Gilman's Deficiency as Being "Attributable To" a Valuation Overstatement Conflicts with Decisions of the Court of Appeals for the Fifth Circuit.

The penalty under section 6659 only applies if the tax deficiency on which it is imposed is "attributable to" a valuation overstatement. The court of appeals held that Gilman's tax deficiency was attributable to a valuation overstatement, following the decision of the Court of Appeals for the Eighth Circuit in *Massengill v. Commissioner*, 876 F.2d 616, 619-20 (8th Cir. 1989). However, *Massengill* and the instant case conflict with the decisions of the Court of Appeals for the Fifth Circuit in *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988), and *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990).

The *General Explanation of the Economic Recovery Act of 1981* prepared by the Staff of the Joint Committee on Taxation (the "Blue Book")[6] explains when a deficiency is "attributable to" a valuation overstatement:

> the portion of a tax underpayment that is attributable to a valuation overstatement will be *determined after taking into account any other proper adjustments to tax liability.* Thus, the underpayment resulting from a valuation overstatement will be determined by comparing [1] the taxpayer's actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with [2] actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement.

Blue Book, *supra* note 6, at 333 (emphasis added).

Under this approach, a tax underpayment created by the disallowance of a deduction for any reason unrelated to the overvaluation of the property is not attributable to a valuation overstatement. The tax underpayment is attributable to the other reason—whatever it may be. *See Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988). In *Todd*, the taxpayers claimed depreciation deductions and tax credits on property that the taxpayers had not placed in service. Placing property in service was a prerequisite for claiming such deductions and credits, and therefore the deductions and tax credits were totally disallowed. Although the taxpayers had also substantially overstated the tax basis of the property, thereby overstating the depreciation deductions and tax credits which were

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6 Staff of the Joint Comm. on Tax'n, *General Explanation of the Economic Recovery Act of 1981* (1981) [hereinafter Blue Book].

Although the Blue Book is not part of the formal legislative history, this Court relied on the Blue Book published as an explanation of the Tax Reform Act of 1969, calling it a "compelling contemporary indication" of the intended effect of the statute. *See Federal Power Commission v. Memphis Light, Gas & Water Division*, 411 U.S. 458, 471-72 (1973).

disallowed, the court of appeals held that the tax underpayment was attributable to the failure to place the property in service and not attributable to the valuation overstatement. The Court of Appeals for the Fifth Circuit, based on the method set forth in the Blue Book, determined that the valuation overstatement had no impact on the ultimate tax liability because the improper deductions and credits were disallowed for a reason unrelated to a valuation overstatement. Thus, no penalty was imposed.

Subsequent to *Todd* the Court of Appeals for the Fifth Circuit made clear that the same rule applies to all tax deductions denied for reasons unrelated to a valuation overstatement. In *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), the taxpayers, who invested in a transaction that lacked economic substance and business purpose, claimed deductions and tax credits on overvalued energy management equipment.[7] The Commissioner argued, and the Tax Court held, that since the taxpayers claimed an overstated basis for the equipment on their tax return, section 6659 applied. The court of appeals, in reversing the Tax Court's imposition of the penalty, explained that:

> [W]e see no reason to treat this case any differently than *Todd*. Whenever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit. In such a case, the underpayment is not attributable to a valuation overstatement. Instead, it is attributable to claiming an improper deduction or credit.

902 F.2d at 383.

In *Massengill v. Commissioner*, 876 F.2d 616 (8th Cir. 1989), the Court of Appeals for the Eighth Circuit reviewed a

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7 Although the taxpayers did not contest the Commissioner's complete disallowance of the deductions and credits, the Tax Court noted the mechanics of the transaction were the same as those of another tax shelter which it had previously found lacked economic substance and business purpose. *Heasley v. Commissioner*, 55 T.C.M. (CCH) 1748, 1750 (1988), *rev'd*, 902 F.2d 380 (5th Cir. 1990).

Tax Court decision that the taxpayers did not have sufficient economic benefits and burdens of ownership to be treated as the tax owners of a herd of cows. In contrast to the holdings in *Todd* and *Heasley*, the Court of Appeals for the Eighth Circuit ruled that "when an underpayment stems from disallowed depreciation deductions or investment credits due to a lack of economic substance, the deficiency is attributable to overstatement of value and subject to the penalty under section 6659." *Massengill*, 876 F.2d at 619-20.

In *Gilman*, the Court of Appeals for the Second Circuit followed the decision in *Massengill* and held that the valuation overstatement penalty applied because Gilman's deductions were totally disallowed for a lack of economic substance. Hence, the decision of the Court of Appeals for the Fifth Circuit in *Heasley* directly conflicts with the approach followed by the court of appeals below and the decision of the Court of Appeals for the Eighth Circuit in *Massengill.*[8]

The Commissioner acknowledges that there is a conflict between the circuits regarding what it means for a tax deficiency to be attributable to a valuation overstatement. In his nonacquiescence to the *Heasley* decision in Action on Decision CC-1991-013 (July 3, 1991) (the "AOD") the Commissioner describes the conflict as follows:

> In *Irom v. Commissioner*, 866 F.2d 545 (2d Cir. 1989), the Second Circuit distinguished *Todd* in a case involving the same "attributable to" language found in section 6621(c). It held that where "the two grounds for [a] deficiency are inseparable" the additional interest may be imposed because the underpayment of tax is "attributable to" both grounds for the disallowance. *Id.* at 547-48. In *Heasley*, the Fifth Circuit said that when the I.R.S. totally disallows a deduction or credit, it may not

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8 In the instant case, the court of appeals' interpretation of the "attributed to" language in section 6659 is similar to its interpretation of the same language in section 6621(c). *See Irom v. Commissioner*, 866 F.2d 545 (2d Cir. 1989).

> penalize the taxpayer for a valuation overstatement included in that deduction or credit as the underpayment is not attributable to a valuation overstatement but to an improper deduction or credit. 902 F.2d at 383.
>
> This statement [in *Heasley*] is broader than either *Todd* or *Irom*. Read literally, *Heasley* would preclude the applicability of section 6659, even where the grounds for disallowance were based on, or integrally related to, a valuation overstatement. We continue to believe that the *Irom* standard is correct and that the oversimplified approach of the Fifth Circuit does not properly reflect the language or purpose of the statute.

In light of the AOD, the Commissioner cannot deny that there is a conflict in the courts of appeals with respect to this issue. The AOD confirms that the Internal Revenue Service (the "IRS") will continue to litigate this issue, impacting upon numerous taxpayers. Prompt resolution of this conflict by this Court is vital because maximum valuation overstatement penalties are being imposed on taxpayers in most circuits for engaging in transactions that are not subject to even the minimum valuation overstatement penalty in the fifth circuit.[9]

Although section 6659 has been repealed for tax years beginning after 1989,[10] the substantive provisions of this section are now incorporated in section 6662(c).[11] Furthermore, the question of when a deficiency is attributable to particular conduct is relevant to most of the accuracy related penalties

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9 Actions on Decision are explanations of the IRS's final legal position on an issue and are widely disseminated to agency personnel for use in legal research and in conferring with the public. *See Taxation With Representation Fund v. Internal Revenue Service*, 646 F.2d 666, 684 (D.C. Cir. 1981).

10 Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(2), 103 Stat. 2106, 2399 [hereinafter 1989 Tax Act].

11 Section 6662(c) was added by the 1989 Tax Act. 1989 Tax Act, *supra* note 10, § 7721(a), 103 Stat. at 2396-97.

contained in section 6662. Therefore, this Court should grant this petition to resolve this conflict.

B. Imposing a Penalty on Tax Underpayments Based Upon the Legal Fiction That Gilman Had a Zero Tax Basis in the Equipment Conflicts with a Decision of This Court.

The reasoning of the court of appeals conflicts with the reasoning of this Court in *Commissioner v. Acker*, 361 U.S. 87 (1959). Under the reasoning of *Acker*, a taxpayer cannot be deemed to have a tax basis in property he does not own merely to justify the imposition of a penalty.

Section 6659 imposes a penalty on tax underpayments scaled to the percentage of overvaluation of property. Under section 6659(c), there is a valuation overstatement only if the property's value or adjusted tax basis claimed on the taxpayer's return is at least 150 percent of the correct amount.

The Court of Appeals for the Second Circuit held that Gilman's purchase of the Equipment lacked "economic substance." The transaction, therefore, was labeled a "tax sham" and treated as if it never occurred.[12] The Court of Appeals admitted that "[t]he application of section 6659(b) to a transaction determined to be without economic substance is not self-evident." Appendix at 15a. The court further stated:

> We acknowledge that applying the penalty [to Gilman's transaction] somewhat *strains* the natural reading of the statutory phrase "valuation overstatement." And where the taxpayer's basis has been reduced to zero, it is somewhat *odd* to apply a provision that scales the penalty rates to the percentage of overvaluation.

Appendix at 17a (emphasis added).

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12 The Commissioner, the Tax Court and the court of appeals never suggested that the transaction did not actually occur. Gilman bought the Equipment for $3 million and leased it for nine years.

The legal standards applied by the court of appeals to label the transaction a "tax sham" conflicts with the legal standards applied by another circuit. This conflict is discussed at Point II, *infra*.

Nonetheless the court applied the penalty on the theory that Gilman should be deemed to have had a zero tax basis in the Equipment because the transaction lacked "economic substance." That theory resulted in an infinite valuation overstatement for purposes of section 6659. This Court has held that it is improper to create a legal fiction which makes one of two amounts zero where a penalty is based on a percentage by which an actual amount differs from an amount claimed on a tax return. *Commissioner v. Acker*, 361 U.S. 87, 91 (1959). In *Acker*, the Commissioner argued that a taxpayer who failed to file any declaration of estimated tax was deemed to have estimated his tax at zero. Under the applicable Code provision, taxpayers were subject to a penalty if they "substantially understated" their tax liability. An understatement was substantial if the taxpayer's estimated tax was less than 80 percent of the actual tax due. The Commissioner argued that Acker was subject to the penalty for substantially underestimating his tax because zero was less than 80 percent of the actual tax due. This Court, in rejecting the Commissioner's claim, stated that:

> [W]e are here concerned with a taxing Act which imposes a penalty. The law is settled that "penal statutes are to be construed strictly," and that one "is not to be subjected to a penalty unless the words of the statute plainly impose it."

Id. at 91 (footnote and citations omitted). This Court held in *Acker* that not making an estimate of tax is not the same as making an estimate of zero for purposes of imposing a tax penalty.

The reasoning that this Court applied to the tax penalty in *Acker* should be applied to the section 6659 penalty imposed on Gilman. Having no tax basis in property, because ownership is ignored for tax purposes, is not the same as having a tax basis of zero. If Gilman's transaction lacked economic substance, then his acquisition of the Equipment is disre-

garded entirely. Gilman, therefore, would not have any basis in the Equipment. His tax basis would not be zero.[13]

Alternatively, Gilman could have had a basis equal to his $3 million cost.[14] Since there was no finding that Gilman paid more than the fair market value, there would be no valuation overstatement.

This Court should agree to review this case to confirm that tax penalties will not be imposed on taxpayers unless the plain words of the statute impose them.

POINT II.

Requiring a Taxpayer to Establish in a Speculative Transaction a "Reasonable Possibility" of Profit as a Prerequisite for the Transaction to Be Respected Conflicts with Decisions of the Court of Appeals for the Sixth Circuit.

The court of appeals held that a transaction must have a reasonable possibility of profit to be respected for tax purposes. This requirement conflicts with the legal standard applied by the Court of Appeals for the Sixth Circuit in the recent decisions of *Bryant v. Commissioner*, 928 F.2d 745 (6th Cir. 1991), *rev'g* 58 T.C.M. (CCH) 235 (1989), and *Smith v. Commissioner*, 937 F.2d 1089 (6th Cir. 1991), *rev'g* 91 T.C. 733 (1988).

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13 For example, the Tax Court will not impose the section 6659 penalty on taxpayers who claim depreciation deductions on property that does not exist. In such cases the Tax Court has correctly held that the taxpayers do not have any basis in the property rather than an adjusted basis of zero. *See, e.g.*, *Weiler v. Commissioner*, 60 T.C.M. (CCH) 1137, 1144 (1990); *Chellappan v. Commissioner*, 55 T.C.M. (CCH) 826, 835 (1988).

14 A taxpayer's basis in property is its cost, whether or not the property was acquired for profit. I.R.C. § 1012.

A. The Court of Appeals Affirmed the Tax Court's Requirement That Gilman Demonstrate a Reasonable Possibility of Profit in Order for His Transaction to Be Respected.

The Tax Court applied the two-pronged test it created in *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 209 (1983), *aff'd in part, rev'd in part*, 752 F.2d 89 (4th Cir. 1985), to determine whether Gilman's transaction was a tax sham. Under that two-pronged test, the Tax Court required that Gilman prove (1) the transaction had "economic substance" or (2) he had a "business purpose" or "profit motive" for entering into the transaction.

The Tax Court held a transaction has "economic substance" if there is " 'reasonable opportunity for economic profit.' " Appendix at 34a (quoting *Gefen v. Commmissioner*, 87 T.C. 1471, 1490 (1986)). Gilman had to prove that in 1980 it was "reasonable to believe" that the residual value of the Equipment would be high enough to return his cash investment. Appendix at 35a. In other words, the Tax Court's test of "economic substance" looked only to whether a prudent investor would have believed that the possibility of breaking even or making a *de minimis* profit was "reasonable." The possibility that Gilman might make a large profit (whether "reasonable" or "unreasonable" to expect) was not considered relevant. Therefore, for purposes of the Tax Court's analysis, the potential profitability of Gilman's transaction turned solely on the residual value of the Equipment in 1989. After hearing expert testimony from both sides as to what a prudent investor in 1980 could have predicted the Equipment might be worth in 1989, the Tax Court held that when Gilman purchased the Equipment there was not a "reasonable possibility" that the Equipment would have sufficient residual value to return Gilman's cash investment.[15] Therefore, the Tax Court held that the transaction lacked "economic substance."

15 The experts' estimates of reasonable residual values ranged from no value to $780,000.

The Tax Court also held that Gilman lacked a business purpose/profit motive.

> If petitioner had a business purpose other than obtaining tax benefits, he would not have committed himself to the transaction until he satisfied himself that there was a *reasonable possibility* that the residual value of the equipment would be great enough to offset his substantial investment in the equipment.

Appendix at 30a (emphasis added). The possibility that Gilman might make a large profit (whether it was "reasonable" or "unreasonable" for Gilman to expect) was not considered relevant. The court of appeals affirmed the application of the two-pronged test, as applied by the Tax Court, requiring that Gilman establish that either (1) a prudent investor would have believed or (2) Gilman himself actually believed, there was a "reasonable possibility" that the Equipment's residual value would at least return his cash investment.

The application of the two-pronged test to a speculative transaction like Gilman's, requiring as it does an evaluation of whether a small profit is "reasonable" to expect, is directly contrary to section 183, the regulations thereunder and the legislative history of that Code provision. In particular, the regulations under section 183 provide nine specific criteria that the court of appeals should have looked to when characterizing the transaction. Of particular relevance in the instant case, those regulations explicitly say that a (1) "reasonable expectation of profit is not required" for a taxpayer to be treated as entering into a transaction for profit and (2) a taxpayer's business purpose/profit motive may be established if "there is a small chance of making a large profit." Treas. Reg. § 1.183-2(a). *See also* Treas. Reg. § 1.183-2(c) Example (5) (activity engaged in for profit even though only small chance of profit).

The court of appeals rejected Gilman's argument that the nine criteria under section 183 should have been used. The court of appeals held that section 183 is only relevant if

Gilman had first established that the transaction had "economic substance," using the Tax Court's strict definition of that term. Since Gilman failed to prove that there was a "reasonable possibility" of breaking even or making a small profit, the court of appeals held that a small chance of a large profit under section 183 was legally irrelevant. *See* Appendix at 11a n.5.

The two-pronged test applied by the Court of Appeals for the Second Circuit, which has also been applied by five other circuits, is in direct conflict with decisions of the Court of Appeals for the Sixth Circuit in two recent cases, *Bryant v. Commissioner*, 928 F.2d 745 (6th Cir. 1991), and *Smith v. Commissioner*, 937 F.2d 1089 (6th Cir. 1991). In these cases, the Court of Appeals for the Sixth Circuit reversed Tax Court decisions and held that a "reasonable likelihood" of profit was not required in order (1) for a transaction to have economic substance and (2) for a taxpayer to have a business purpose/profit motive for entering into a transaction. Under the law in the Sixth Circuit, Gilman's transaction would not have been a "tax sham."

B. In *Bryant*, the Court of Appeals for the Sixth Circuit Held That a Transaction Need Not Have a Reasonable Possibility of Profit to Be Respected.

In *Bryant*, the taxpayer invested in a tax shelter called the Summit Gold Mine. The Tax Court found that the taxpayer could not have reasonably expected a profit from the transaction apart from its tax benefits. Therefore, it held his investment lacked "economic substance." The Tax Court did not use the criteria in the regulations under section 183 in making that determination.

On appeal, the Court of Appeals for the Sixth Circuit reversed the Tax Court on several points. The court of appeals held that only truly abusive tax shelters lack economic substance. The court rejected the Tax Court's strict definition of "economic substance," holding instead that a reasonable possibility of profit was *not* required. The court

of appeals followed its earlier decision in *Rose v. Commissioner*, 868 F.2d 851 (6th Cir. 1989), defining economic substance based solely upon whether the taxpayer's investment had " 'any practicable economic effects' " other than to reduce taxes. 928 F.2d at 748 (*quoting Rose*, 868 F.2d at 853). Viewed at the time of his investment, the practicable economic effects of the Summit Mine transaction on Bryant were clear. First, the Summit Mine had been a bona fide operating mine. Second, substantial money had been spent developing it. Third, ore was produced from the mine until it was no longer economical to do so. And fourth, Bryant had analyzed the transaction the same way he had analyzed prior mining investments. Based on these factors, the court held that Bryant's investment had "practicable economic effects" on him. Therefore, it had economic substance. 928 F.2d at 748.

The court directed the Tax Court on remand to apply the criteria under section 183 to determine whether Bryant had a profit motive.[16] The court rejected the Tax Court's requirement that the profit potential of Bryant's investment be reasonable before any deductions could be allowed.

> "[I]n determining whether losses from an activity are to be allowed, the focus is to be on whether the activity is engaged in for profit rather than whether it is carried on with a reasonable expectation of profit."

928 F.2d. at 749 (quoting S. Rep. No. 552, 91st Cong., 1st Sess., *reprinted in* 1969 U.S. Code Cong. & Admin. News 2027, 2133). The court remanded the case to the Tax Court, with the following instructions:

> On remand, the court should not engage in an independent inquiry of whether the Summit Gold Mine was

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16 The Tax Court did not originally decide whether Bryant had a profit motive under section 183 because it believed that Bryant's investment lacked "economic substance." As did the Court of Appeals for the Second Circuit in the instant case, the Tax Court in *Bryant* did not believe section 183 was relevant unless the transaction had "economic substance."

> *likely* to be profitable. Instead, the court should determine from the facts and circumstances surrounding the investment whether the taxpayer entered the activity with the objective of making a profit, keeping in mind that a small chance of making a large profit can support a profit motive.

928 F.2d at 750 (emphasis in original). Bryant's argument under section 183 and its legislative history was exactly the same argument that Gilman made in the instant case. The Court of Appeals for the Sixth Circuit agreed with it. The Court of Appeals for the Second Circuit rejected it.[17]

C. In *Smith*, the Court of Appeals Once More Rejected the Tax Court's Requirement That a Transaction Have a Reasonable Possibility of Profit to Be Respected.

The Court of Appeals for the Sixth Circuit reached the same conclusion in *Smith v. Commissioner*, 937 F.2d 1089

17 The Court of Appeals for the Second Circuit distinguished *Bryant*, which was decided after the briefing closed, holding that the rule in section 183 not requiring a "reasonable" profit potential is only applicable to "risky business ventures, typified by the wildcat oil well, not the residual value in equipment at the end of a nine-year lease." Appendix at 11a n.5. It is unclear upon what assumption the court's comment was based. If based upon the belief that Gilman's investment was not "risky enough," such a conclusion is intellectually inconsistent with the Tax Court's conclusion that an expectation of profit was "unreasonable." An "unreasonable" expectation of profit is *per se* risky. If, on the other hand, the Court meant that Gilman's profit potential on his net cash investment was not large enough for section 183 to apply, such a conclusion would have been unsupported by the facts. There was no finding as to the potential magnitude of Gilman's profit if inflation continued at high rates or the pace of computer technology slowed. In fact, due to the high leverage Gilman used to buy the Equipment (his acquisition debt as a percentage of his $3 million cost), the out-of-pocket cash Gilman invested was small compared to the potential residual value of the Equipment which Gilman was assured of getting free and clear in 1989. If Diebold's estimated residual value of $600,000 (20% of cost) had been correct, Gilman's pre-tax net profit would have been more than $146,000. He would have doubled his cash investment at a 29% residual. He would have tripled it at 44%.

(6th Cir. 1991), as it reached in *Bryant*. Smith was a partner in a speculative tax shelter partnership. The partnership entered into a joint venture with another partnership to develop technology for a synthetic fuel called K-Fuel. The Tax Court held the transaction lacked a reasonable possibility of some profit and, therefore, lacked "economic substance."[18]

The Court of Appeals for the Sixth Circuit reversed the Tax Court and held that the K-Fuel activity was not a tax sham. It reaffirmed its decision in *Bryant* that a court is not to examine a taxpayer's profit motive in determining the economic substance of a speculative transaction.

> The conclusion in *Bryant* was similar to the one we reach in this case—"a reasonable expectation of profit [subjectively] is not to be required;" . . . Here, as in *Bryant*, we conclude that the Tax Court was in error in questioning the transaction on the basis of whether it was "*likely*" to be profitable.

937 F.2d at 1097 (emphasis in original).

The Court of Appeals for the Sixth Circuit found that the K-Fuel transaction had economic substance because it could have had some practicable economic effect on Smith other than the creation of tax losses. First, although it was a speculative activity the financial success of which was highly unlikely, 937 F.2d at 1092, 1094, there was some evidence in the record that the K-Fuel process may have been economically feasible. Second, Smith was personally liable for his share of the indebtedness incurred to develop the K-Fuel project. Finally, it was expected that the indebtedness would be repaid out of future taxable income Smith's partnership

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18 A taxpayer named Karr was an investor in the other partnership. Since Karr's partnership engaged in the same K-Fuel project as Smith's, Karr's tax case was consolidated with Smith's in the Tax Court. Both taxpayers lost in the Tax Court. Smith appealed his case to the Court of Appeals for the Sixth Circuit which reversed the Tax Court. Karr appealed his case to the Court of Appeals for the Eleventh Circuit which affirmed the Tax Court. *See Karr v. Commissioner*, 924 F.2d 1018 (11th Cir. 1991).

would earn. Thus, the court stated it was "obvious" that Smith's investment was not a tax sham.[19]

The court in *Smith* applied the criteria under section 183.[20] Although Smith's expectation of profit was unreasonable and the probability of any profit was slight, the court, nonetheless, held that he had a business purpose/profit motive under those criteria. *Id.* at 1097.

D. Gilman's Transaction Had Economic Substance Under the Analysis Applied by the Court in *Smith* and *Bryant*.

Gilman's transaction had "practicable economic effect" under the analysis applied by the court in *Bryant* and *Smith*. First, the Equipment was real and leased to end user-lessees. Second, it is undisputed that Gilman actually bought the Equipment for $3 million, investing more than $469,000 of his own out-of-pocket cash to do so. Third, more than $2.3 million of the indebtedness Gilman incurred in the transaction was fully recourse against him. If Gilman's lessee failed to pay the rent it owed, Gilman still would have been personally liable to pay his lenders. Fourth, the Equipment would produce over $6 million of rental income for Gilman under the Lease, paying off his acquisition debt completely and giving him almost $76,000 of cash flow. Fifth, by 1989 Gilman would own the Equipment free and clear of all liens, encumbrances and pre-existing user leases. Whatever it would be worth belonged to him. Finally, Gilman analyzed his invest-

19 937 F.2d at 1096. The court acknowledged that its broader definition of economic substance was in direct conflict with the narrower definition of that term as applied by the Eleventh Circuit in *Karr*.

> We recognize that this result is at odds with the Eleventh Circuit's decision in *Karr* . . . , but under the law of this circuit, the proper test is "whether the transaction has *any* practicable effects other than the creation of income tax losses."

Id. (emphasis in original) (*quoting Rose v. Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989)).

20 The Tax Court in *Smith* had not done so since it disregarded the transaction as a sham. The Court of Appeals for the Eleventh Circuit in Karr's appeal failed to apply the criteria in section 183 as well. The Court of Appeals for the Second Circuit in *Gilman* did the same.

ment in exactly the same way that he had analyzed prior equipment investments for Gilman Paper Company, his wholly owned corporation with approximately 2500 employees ("Gilman Paper"). In short, Gilman's investment had "practicable economic effect" on him. Therefore, the transaction had economic substance using the standard adopted by the Court of Appeals for the Sixth Circuit and, had Gilman appealed to such court, the transaction would not have been disregarded as a tax sham.

E. The Result Below Cannot Be Reconciled With *Bryant* and *Smith*.

The Commissioner may assert that even using the Court of Appeals for the Sixth Circuit's sham transaction analysis set forth in *Bryant* and *Smith*, Gilman's transaction would still be characterized as a sham under that court's earlier decision in *Rose v. Commissioner*, 868 F.2d 851 (6th Cir. 1989), and therefore, no conflict is present on this issue. However, *Rose*, which involved a truly abusive tax shelter, is easily distinguished.

The taxpayer in *Rose* purportedly purchased "reproduction masters" of artists' originals through the Jackie Fine Arts tax shelter program. Rose claimed enormous tax credits, depreciation and interest deductions attributable to the transaction. Rose made the purchase "[w]ithout investigation of the highly sophisticated art market" and without any independent appraisals of value. 868 F.2d at 854. The reproductions had no proven market or marketability, and the Tax Court found that their fair market value was negligible. 868 F.2d at 852. Yet Rose purportedly "paid" over $1 million for them. Substantially all of that amount was in the form of notes unlikely to be repaid. *Rose v. Commissioner*, 88 T.C. 386, 420 (1987), *aff'd*, 868 F.2d 851 (6th Cir. 1989). Rose reported no income from sales of any reproductions, and he neither sought nor received information on how to exploit the reproductions commercially. Although the Court of Appeals for the Sixth Circuit rejected the Tax Court's legal analysis in *Rose*, it affirmed treatment of the transaction as a tax sham

because the Tax Court's findings made clear that the transaction could not have had "any practicable economic effect" on Rose other than the creation of tax benefits.

The practicable economic effects of Gilman's transaction clearly distinguish it from *Rose*. First, there was an established market for the Equipment. Diebold's appraisal stated unequivocally that the $3 million price Gilman paid was a fair market value price.[21] Second, Gilman had substantial knowledge of computers and equipment leasing. He had caused Gilman Paper to purchase and to lease computer equipment in prior years for use in its own business. In addition, he had caused Gilman Paper to purchase and lease over $40 million worth of railroad cars. Third, Gilman's acquisition indebtedness was actually paid off in full by the end of the Lease. A substantial portion of that indebtedness was paid out of Gilman's rental income. Diebold's appraisal confirmed that the rent Gilman would receive under the lease was a fair market value rent for the Equipment. That rental income, in fact, totaled over $6 million.[22] And fourth, at the end of the Lease, Gilman would own the Equipment free and clear; whatever it was worth at that time belonged to him. In short, Gilman's transaction cannot be characterized as the purchase of assets with a negligible value and no commercial use at a grossly inflated purchase price which would never be paid off. Therefore, *Rose* is clearly distinguishable, and under *Bryant* and *Smith*, the economic substance of Gilman's transaction would be respected by the Court of Appeals for the Sixth Circuit.

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21 The Tax Court made no finding that Gilman's purchase price did not represent fair market value. The only finding by the Tax Court as to the economic aspects of the transaction was that the term of the Lease was too long for the Equipment to have a residual value when the Lease expired sufficient to return Gilman's cash investment.

22 There was nothing in the record indicating, nor did the Tax Court make any finding, that Gilman's rental income under the lease differed from fair market value rent. The Commissioner and his experts at trial never questioned whether the rent Gilman received was fair market value rent.

F. This Court Should Review This Case to Establish a Consistent Standard for Determining When a Transaction Has a Sufficient Potential for Profit to Be Respected.

This Court should grant certiorari in this case because there is currently no consistent standard for determining (1) whether the profit potential of a transaction must be reasonable and (2) the relevance of section 183 to speculative transactions providing Congressionally mandated tax benefits for investors. A decision by this Court would lend predictability to an area of the tax law where the variety of analyses used by courts has been described as "mind-numbing." *See* Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 Colum. L. Rev. 657, 684 (1985). The lack of predictability created by this confusing state of affairs undermines judicial efficiency and makes settlement of cases more difficult. That fact has been confirmed by Kenneth Gideon, Assistant Secretary of the Treasury for Tax Policy. *See* Gideon, *Mrs. Gregory's Grandchildren: Judicial Restriction of Tax Shelters*, 5 Va. Tax Rev. 825, 826 (1986).

There is no consistent standard for exactly "how much" pre-tax profit potential is required for a transaction to be respected for income tax purposes. *See id.* Some courts have held that a profit motive exists if: (i) there is *any* potential non-tax return, *see, e.g., Goldstein v. Commissioner*, 364 F.2d 734, 741-42 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967); (ii) the non-tax rate of return on the investment is equal to or greater than an arbitrarily determined rate of return, *see, e.g., Hilton v. Commissioner*, 74 T.C. 305, 353 n.23, 355-56 (1980), *aff'd per curiam*, 671 F.2d 316 (9th Cir.), *cert. denied*, 459 U.S. 907 (1982); (iii) tax benefits are not the "primary" motive for the transaction, *see, e.g., Fox v. Commissioner*, 82 T.C. 1001, 1025 (1984); (iv) the potential non-tax profit is sufficiently large compared to the tax benefits, *see, e.g., Estate of Baron v. Commissioner*, 83 T.C. 542, 558 (1984), *aff'd*, 798 F.2d 65 (2d Cir. 1986); or (v) the taxpayer is not "completely indifferent" to the success or failure of the venture, *see, e.g., id.* at 560. Some courts have

held that a taxpayer's expectation of profit need not be reasonable. *See Bryant v. Commissioner*, 928 F.2d 745, 750 (6th Cir. 1991); *Smith v. Commissioner*, 937 F.2d 1089, 1097 (6th Cir. 1991); *Jacobson v. Commissioner*, 915 F.2d 832, 838 (2d Cir. 1990); *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963). Other courts, such as the court below, require that any expectation of profit must be reasonable.

In addition to the court of appeals below, a number of courts of appeals have accepted or endorsed the Tax Court's position that transactions will not be respected unless there is a reasonable possibility of profit. *See, e.g., Hunt v. Commissioner*, 938 F.2d 466, 471 (4th Cir. 1991) (master recording transaction a sham if " 'no reasonable possibility of a profit exists' ") (*quoting Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985)); *Karr v. Commissioner*, 924 F.2d 1018, 1025 (11th Cir. 1991) (Tax Court properly found that gold mine transactions lacked economic substance since no reasonable profit potential existed); *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990) (affirming Tax Court's holding that equipment lease transaction lacked economic substance because taxpayers did not have reasonable possibility of profit); *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1990) (equipment lease transaction a sham if " 'no reasonable possibility of a profit exists' ") (*quoting Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985)); *Shriver v. Commissioner*, 899 F.2d 724, 726 (8th Cir. 1990) ("The economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits."). After a substantial number of lower court decisions have been made in a field like this, so that the area is "mature," it is appropriate for this Court to resolve the basic conflicts which have developed.

The situation here is similar to that in other cases heard by this Court, where there was a need for the Supreme Court to settle the law in a particular area. *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Commissioner v.*

Culbertson, 337 U.S. 733 (1949); *Helvering v. Clifford*, 309 U.S. 331 (1940).

It is unfair to taxpayers trying to plan for transactions with speculative returns to have to predict whether, in retrospect, the Commissioner or a court may conclude that a given transaction did not have a "reasonable possibility" of profit. That is particularly the case in speculative and high risk transactions that serve an economic objective identified by Congress. To compensate for that risk, Congress often provides substantial tax benefits to taxpayers willing to enter into such transactions. The accelerated depreciation deductions Gilman claimed were just such a tax benefit.[23] Taxpayers deserve to know whether the tax benefits Congress crafted to motivate speculative investments may be stifled by retroactive application of a sham theory to transactions the Commissioner thinks were too speculative.

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23 *See Levy v. Commissioner*, 91 T.C. 838, 871-72 (1988) (equipment leasing tax shelters are tax motivated transactions that Congress meant to encourage by allowing accelerated depreciation deductions).

In fact, a number of Code sections provide special tax benefits for high risk activities. *See, e.g.*, I.R.C. § 28 (credits for developing drugs to cure rare diseases); I.R.C. § 29 (credits for producing alternative fuels); I.R.C. § 41 (credits for increasing research activities); I.R.C. § 42 (low income housing credits); I.R.C. § 174 (research and experimental costs); I.R.C. § 263(c) (intangible drilling costs for oil wells); I.R.C. §§ 616, 617 (exploration and development costs for mines).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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October 15, 1991

APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 921—August Term 1990

Argued: February 4, 1991 Decided: May 14, 1991

Docket No. 90-4127

HOWARD GILMAN,

Petitioner-Appellant,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Before:

NEWMAN and ALTIMARI, *Circuit Judges,* and CONBOY, *District Judge.**

Appeal from the December 28, 1989, decision of the Tax Court (Charles E. Clapp II, Judge) upholding the disallowance of income tax deductions and imposing a penalty tax and a penalty interest rate because of a valuation overstatement.

Affirmed.

* The Honorable Kenneth Conboy of the District Court for the Southern District of New York, sitting by designation.

R. DONALD TURLINGTON, New York, N.Y. (James A. Gouwar, Bennett I. Deutsch, Stuart B. Katz, Brown & Wood, New York, N.Y., on the brief), *for petitioner-appellant.*

JONATHAN S. COHEN, Tax Div., Dept. of Justice, Wash., D.C. (Shirley D. Peterson, Asst. Atty. Gen., Gary R. Allen, Nancy G. Morgan, Tax Div., Dept. of Justice, Wash., D.C., on the brief), *for respondent-appellee.*

JON O. NEWMAN, *Circuit Judge*:

The principal issue on this appeal is whether a sale/lease-back transaction had sufficient economic substance to warrant income tax deductions for depreciation and interest. Howard Gilman appeals from the December 28, 1989, decision of the Tax Court (Charles E. Clapp II, Judge) upholding the disallowance of deductions and imposing a penalty tax and a penalty interest rate because of a valuation overstatement. We affirm.

Facts

The taxpayer is the chief executive officer and chairman of Gilman Paper Company. In November 1980, Joel Mallin, a broker in equipment leasing deals, sought Gilman's individual participation in the sale and lease-back of some computer equipment that had already been purchased and leased to end-users. Between 1978 and 1980, Disko, a West German company engaged in leasing equipment to end-users in Europe, bought the

computer equipment that is the subject of this case. The purchase price of approximately $4.1 million was financed by loans from Disko's parent company, Dresdner Bank (of West Germany). Disko then leased the equipment to end-users in Europe.

With Gilman's agreed participation, the computer equipment transaction continued. Two additional companies became involved in the transaction, Equilease B.V. ("Equilease") and Aardan Leasing Corporation ("Aardan"). Equilease was a Netherlands corporation engaged in the sale, finance, and lease of computer equipment. Equilease had substantial United States activities and was unrelated to Disko. Aardan was a United States corporation unrelated to Disko or Equilease.

On December 30, 1980, Equilease purchased the computer equipment from Disko for $2,740,808, subject to the end-user leases and Dresdner Bank's security interest. Equilease leased the equipment back to Disko for a term of nine years. On December 31, 1980, Equilease sold the equipment to Aardan for $2,992,500, subject to Disko's lease, the end-user leases, and Dresdner Bank's security interest.[1] The same day, Aardan sold the equipment to the taxpayer, Gilman, for $3 million. Gilman then leased the equipment to Equilease for a term of nine years.

Gilman paid $45,000 in cash and signed an interest bearing note in the principal amount of $2,955,000. In form, almost $2 million of this long-term note was

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1 According to Mallin's testimony, Aardan was inserted into the transaction as a "middle company" in an effort to comply with the "at risk" provisions of 26 U.S.C. § 465 (1976). Aardan was incorporated on December 29, 1980, two days before it purchased the computer equipment.

recourse, but it was secured by the equipment and its rental income. Gilman's monthly payments of $65,619.32 on the long-term note began in January 1983. Simultaneously, Gilman was scheduled to receive $66,319.32 monthly from Equilease on its lease. Therefore, the monthly rental income from the computer equipment covered, with some excess, the long-term note payments Gilman was obligated to make under the equipment purchase agreement. Also, the long-term notes provided that Gilman could defer payment up to fourteen years if he failed to receive his corresponding lease payments from Equilease.

The interest that would accrue on the long-term note in 1981 and 1982 was paid in the form of two short-term recourse notes with a total face value of $375,000 plus interest on the short-term notes of $49,597. The notes were secured by letters of credit from Gilman's bank, Morgan Guaranty Trust Company. In summary, Gilman's total cash investment was $469,597, comprising his $45,000 down payment, the $375,000 face amount of the short-term notes, and the $49,597 interest on the short-term notes.

On his 1980 and 1981 tax returns, Gilman reported this computer transaction as a $3 million purchase, took deductions for depreciation and interest, and included as income the rent received from Equilease. The Commissioner disallowed these tax deductions, excluded the rental income, and issued Gilman a notice of deficiency for the tax years 1980 and 1981 in the amounts of $171,680 and $329,555, respectively. The Commissioner classified the 1981 underpayment as due to a valuation overstatement and assessed a section 6659 penalty tax of

$98,867.[2] In addition, the Commissioner viewed both years' underpayments as the result of a tax-motivated transaction and applied the section 6621(c) penalty rate of interest.[3] Gilman filed a petition with the Tax Court.

The Tax Court identified six issues: (1) should the transaction be respected for federal income tax purposes, (2) was this transaction "for profit" within the meaning of 26 U.S.C. § 183 (1969), (3) was Gilman "at risk," as defined in section 465, with respect to his indebtedness, (4) was the appropriate method of depreciation used, (5) was any underpayment of tax attributable to a valuation overstatement as defined in section 6659, and (6) was the transaction tax-motivated as defined in section 6621(c).

In considering whether the transaction should be respected for federal income tax purposes, the Court noted that in the context of sale/leaseback transactions, the non-user owner must establish that

> "the entry into the transaction was motivated by business purpose to justify the form of the transaction, and that the transaction was supported by economic substance. *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 201-203. In *Rice's Toyota World, Inc.*, we stated that the tests developed under the sham transaction doctrine are applied to determine whether a threshold level of business purpose or economic substance is present. *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 196."

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2 The section 6659 penalty tax was not assessed against the 1980 tax return because the provision became effective only for returns filed after December 31, 1981.

3 The subsection was redesignated from (d) to (c) by section 1511(c)(1)(A) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2744. The provision will be cited hereafter as section 6621(c).

Gilman v. Commissioner, 58 T.C.M. (CCH) 1075, 1078 (1989) (quoting *Larsen v. Commissioner*, 89 T.C. 1229, 1251-52 (1987), *aff'd in relevant part*, *rev'd in part sub nom. Casebeer v. Commissioner*, 909 F.2d 1360 (9th Cir. 1990). The Tax Court further stated that "[t]he presence of business purpose does not entitle a transaction to be recognized for Federal tax purposes where objective indicia of economic substance indicating a realistic potential for economic profit are not manifest." *Id.* (quoting *Larsen*, 89 T.C. at 1252 (1987)).

Applying this standard, the Court first concluded that if Gilman had had a business purpose other than tax benefits, "he would not have committed himself to the transaction until he satisfied himself that there was a reasonable possibility that the residual value of the equipment would be great enough to offset his substantial investment in the equipment." *Id.* Gilman claimed that he relied on the residual value figure provided by Diebold Deutschland BmbH ("Diebold"), a West German computer company hired by Equilease to appraise the equipment. Gilman also contended that it was unnecessary to obtain a second appraisal because Diebold was well recognized in the German market.

However, the Tax Court found that the only residual value figure that Gilman saw prior to the transaction was the one provided by Mallin indicating a 20 percent net residual value. The Court rejected Mallin's assertion that the figure was a quote he had received from Diebold through Equilease. The only oral appraisal received prior to closing was received not by Gilman's attorney as alleged but by an associate in his attorney's firm. And it was not an appraisal from Diebold but rather a confirmation from Equilease of what Diebold's

forthcoming appraisal would conclude. The Diebold appraisal that arrived in January 1981 provided Gilman no protection because the sale/leaseback transaction was not conditioned on receipt of a satisfactory appraisal.

Gilman's lack of interest in the residual value of the equipment was a key factor in the Tax Court's analysis of the transaction. Even if the equipment had no residual value, Gilman would have received a cumulative net benefit of $142,150 at the end of 1989, primarily through the investment of up-front tax benefits. With his cash investment of $469,597, Gilman would have been much more interested in the residual value of the equipment if his motivation had been business and not tax benefits. The Court concluded that "[t]he $8,400 per year of excess rent over principal and interest payments was a mere pittance that could not produce a business purpose in the mind of a reasonably astute businessman." *Id.* at 1080.

In determining whether the sale/leaseback transaction was a sham, the Court also considered whether the transaction had economic substance, noting that a transaction " 'has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits.' " *Id.* (quoting *Gefen v. Commissioner*, 87 T.C. 1471, 1490 (1986)). The Court approached the analysis from the standpoint of the prudent investor. *See Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 209 (1983), *aff'd in part, rev'd in part*, 752 F.2d 89 (4th Cir. 1985) (affirming the finding that transaction was a sham and the disallowance of depreciation and interest deductions on nonrecourse debt). The Court, however, gave some consideration to the tax-

payer's subjective statement as to his non-tax motive. *See Cherin v. Commissioner*, 89 T.C. at 992.

Gilman would earn a non-tax based profit on this transaction only if the residual value exceeded $437,774, or 14.6 percent of the original purchase price.[4] Therefore, Gilman was required to demonstrate that "a prudent investor could have concluded that there was a realistic opportunity that the residual value of the equipment at the end of the lease would have exceeded 14.6 percent of the original purchase price." *Gilman*, 58 T.C.M. at 1080. Gilman and the Commissioner presented experts to testify as to what were reasonable expectations, at the time of the transaction, of the residual value. Because Gilman's experts presented contradictory, incomplete, and unsupported conclusions regarding useful life, scrap value, price decline, and the effect of innovation and development in the computer industry, the Court found "the appraisals of [the Commissioner's] experts to be sufficiently more convincing than those of [Gilman's] experts and conclude[d] that in December 1980 a prudent investor would have concluded that the equipment would have only a nominal residual value in December 1989." *Id.* at 1083.

Since the taxpayer lacked a business purpose and his transaction lacked economic substance, the Tax Court deemed the sale/leaseback transaction a sham, not to be respected for federal tax purposes. The Court disallowed the deductions, and found Gilman liable under the penalty provisions of sections 6659 and 6621(c). The tax-

4 This calculation is based on Gilman's net investment of $393,997 (the $469,597 cash investment minus the income of $8,400 per year for nine years from Equilease) and the fact that Equilease was entitled to retain 10 percent of the residual value of the equipment.

payer filed a motion asking the Tax Court to vacate or revise its decision and permit the taxpayer to deduct the $12,452 of interest paid in 1981 on the short-term notes. Since the Commissioner conceded that the taxpayer was entitled to this deduction, the Tax Court vacated its original decision and entered a new decision under Rule 155 of the Tax Court Rules of Practice and Procedure. *Gilman v. Commissioner*, 59 T.C.M. (CCH) 465 (1990). Thus, Gilman was assessed deficiencies of $171,680 for 1980, and of $320,135 for 1981, along with a section 6659 penalty tax of $96,040.50 for 1981. The penalty interest rate under section 6621 was applied to the underpayments for both tax years. Gilman appealed.

Discussion

I. Was the sale/leaseback a sham transaction?

On appeal, the taxpayer first argues that the Tax Court applied the wrong legal standard in determining whether his transaction was a sham. Gilman claims that the Court erred in applying the two-pronged legal standard of *Rice's Toyota* (business purpose and economic substance). Relying on our recent decision in *Jacobson v. Commissioner*, 915 F.2d 832 (2d Cir. 1990), Gilman contends that the relevant standard for determining economic substance is "whether the transaction may cause any change in the economic positions of the parties (other than tax savings)," and "that the 'profit motive/business purpose' inquiry should be based on the criteria in the regulations under section 183." Brief for Appellant at 15.

Gilman's argument is premised on an incorrect reading of *Jacobson*. In that case we rejected the Tax

Court's finding that a film transaction was a sham, where the Tax Court had relied on its subjective opinion of the film. However, we explicitly supported the business purpose/economic effect analysis of sham transactions: " 'A transaction is a sham if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions.' " *Jacobson*, 915 F.2d at 837 (quoting *DeMartino v. Commissioner*, 862 F.2d 400, 406 (2d Cir. 1988)). We also noted that a court could either inquire whether there were any non-tax economic effects or use the analysis under section 183. *Id.* at 837-38. Whether the terminology used was that of "economic substance, sham, or section 183 profit motivation" was not critical; what was important was reliance on objective factors in making the analysis. *Id.* at 838.

The taxpayer also misunderstands the *Rice's Toyota* two-pronged test and its application in the present case. In *Rice's Toyota*, the Court was assessing the validity of a sale/leaseback transaction. The Court stated that the "sham transaction theory" "requires that business transactions meet a minimum threshold of a business purpose or economic objective." *Rice's Toyota*, 81 T.C. at 209. Having failed to find business purpose, the Court in *Rice's Toyota* then "examine[d] the transaction for economic substance, an objective test. [This required that the Court] analyze the transaction as a prudent businessman would to ascertain whether it had any economic substance apart from its beneficial tax consequences." *Id.*

In the present case, the Tax Court did not demand that the taxpayer demonstrate both business purpose and economic substance. Rather, the Court examined

each prong separately and concluded that Gilman lacked a business purpose and that the transaction lacked economic substance. The Tax Court applied the sham analysis consistent with the guidelines of this Circuit and others, indicating the flexible nature of the analysis. *See Jacobson*, 915 F.2d at 837-38; *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990); *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir.), *cert. denied*, 488 U.S. 824 (1988); *see also Zmuda v. Commissioner*, 731 F.2d 1417, 1420 (9th Cir. 1984).

The taxpayer relies on *Rosenfeld v. Commissioner*, 706 F.2d 1277 (2d Cir. 1983), and *Commissioner v. Brown*, 380 U.S. 563 (1965), to argue that where a transaction changes the beneficial and economic rights of the parties it cannot be a sham. But the Commissioner does not contend that Gilman does not own the computer equipment. Instead, the concern is that his entry into the transaction was motivated by tax consequences and not by business or economic concerns.[5]

Gilman's second argument is that even if the Tax Court applied the proper legal standard, his transaction

5 The taxpayer argues that the Tax Court erred in requiring a reasonable possibility of profit because the regulations under section 183 state that "a reasonable expectation of profit is not required." Treas. Reg. § 1.183-2(a) (1972). However, Gilman's assertion of error is incorrect on two grounds. First, even according to Gilman's own analysis, section 183 applies after a transaction has been determined to have economic substance. The Tax Court concluded that Gilman's transaction lacked economic substance. Second, both the regulation and *Jacobson* refer to the expectations of profit in the context of risky business ventures, typified by the wildcat oil well, not the residual value in equipment at the end of a nine-year lease. *See also Bryant v. Commissioner*, No. 90-1439, slip op. (6th Cir. Mar. 22, 1991) (risky nature of gold mine venture does not render it a sham). Additionally, the Tax Court in the present case made reference to the expectation of profit in an effort to identify the kind of information a businessman would seek before entering into this transaction.

was not a sham under the *Rice's Toyota* two-pronged test. To demonstrate that he had a business purpose, Gilman refers to the spreadsheet that he and his advisors reviewed, the businesslike manner in which he conducted the transaction, and his own ability to evaluate the transaction based on personal business experience. Gilman objects to the reasoning of the Tax Court that he should have obtained an oral or written appraisal before committing himself and should have sought a second appraisal. However, Gilman fails to show that the Tax Court was clearly erroneous in concluding that the evidence regarding his minimal efforts to determine the residual value and secure a reasonable estimate prior to entering the transaction were inconsistent with a business purpose, particularly in light of the surrounding circumstances of the transaction.

The Court's conclusion that Gilman lacked a business purpose was not based on the view that Gilman had poor advisors. Instead, it reflected the fact that the tax benefits were the motivation: once the documentation established those benefits, Gilman was unconcerned about residual value. Even if the residual value was zero, the tax benefits made the arrangement attractive to Gilman.

With respect to economic substance, Gilman argues that the combination of a fair purchase price, fair rent received, guaranteed cash flow, residual value, and trusted advisors all indicate the substance of the transaction. However, the most important element for economic substance in this transaction was the residual value. As the Tax Court noted, the residual value had to be greater than 14.6% of the original value for Gilman to recoup his investment. Gilman claims that there can

be more than one reasonable estimate in 1980 of the residual value of the equipment in 1989. This statement is correct, and the Tax Court recognized that its inquiry was limited to what was reasonable to believe in 1980, not which expert was correct in 1990. As noted earlier, the Court found Gilman's experts' testimony vague, unsupported, contradictory, and incomplete. The Court was entitled to conclude that their estimates of residual value were "not based on sound and logical reasoning" and were "not credible." *Gilman*, 58 T.C.M. at 1081-82.

In contrast, the Court viewed the testimony of the Commissioner's experts as supported by and drawing upon data, publications, and appraisals existing at the time of this transaction. The reports of the Commissioner's experts took into consideration the impact of technological development and innovation on the residual value of the computer equipment. While the Court observed at the outset that it was not bound by the opinions of any of the experts, it concluded in the end that the Commissioner's experts provided a realistic picture of what the reasonable investor would have believed in 1980, and that it was not "reasonable to conclude that such equipment would have any measurable residual value 9 years after [Gilman's] purchase." *Id.* at 1083.

The taxpayer has failed to demonstrate that the Tax Court's finding that the sale/leaseback transaction was a sham was clearly erroneous.

II. Application of the penalty tax

The Tax Court imposed an overvaluation penalty based on Gilman's 1981 tax return. Pursuant to section

6659, a penalty is imposed where there is an underpayment of tax "attributable to a valuation overstatement" of property on the tax return. The amount of the penalty is a percentage of the underpayment; the applicable percentage is based on the degree of overvaluation. Under the tax laws in effect during the relevant period, a 30 percent penalty was assessed where the property was valued on the return at more than 250 percent of its correct value or adjusted basis. Section 6659(b).

The Tax Court calculated a deficiency of $329,555 on the 1981 return, based on the disallowance of the deductions for depreciation and interest and the exclusion of rental income.[6] Then the Court concluded that the correct adjusted basis of the computer equipment was zero, and not the $3 million claimed by the taxpayer. With the basis at zero, the percent of overvaluation was infinite; the Court therefore applied the maximum penalty percentage rate, 30 percent, since the property was overvalued by more than 250 percent. Section 6659(b). A penalty of $98,867 (30 percent of the underpayment attributable to the overvaluation, *i.e.*, $329,555) was added to Gilman's 1981 taxes.

Gilman challenges the overvaluation penalty on two grounds. First, he contends that section 6659(b) is totally inapplicable because there was no "valuation overstatement" within the meaning of the penalty provision. The Commissioner, says Gilman, did not contend that Gilman claimed too high a basis; instead, the claim was that the sale transaction was a sham and that

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6 This figure is from the Tax Court's original opinion, prior to the adjustment for the deduction of interest paid on the short-term notes. The difference is not relevant to the arguments regarding application of section 6659.

Gilman had no basis at all. Second, Gilman contends that if there was an overstatement, the deficiency was not attributable to it, as required by section 6659(b). We think the Tax Court properly rejected both contentions.

The application of section 6659(b) to a transaction determined to be without economic substance is not self-evident. The statute is most appropriately applied to instances where a taxpayer claims for an asset a value that the Commissioner determines is unduly high. The paradigmatic case is the inflated value claimed for a work of art in order to obtain a large deduction for a charitable donation. That is the example provided in the legislative history when the specific penalty for overvaluation was first adopted in 1981. *See* Joint Committee on Taxation, *General Explanation of the Economic Recovery Act of 1981*, 97th Cong., 1st Sess. 334, *reprinted in Internal Revenue Acts 1980-1981* 1704 (1981).

Application of the overvaluation penalty in the context of tax shelter transactions challenged as lacking economic substance appears to have developed from a series of cases involving cattle breeding. The sequence begins with *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981). The taxpayer used a small amount of cash and substantial nonrecourse loans ostensibly to acquire interests in cattle. The Commissioner primarily contended that in reality no sale had occurred and that all depreciation deductions should be disallowed. Alternatively, he argued that only limited depreciation deductions should be allowed based on a fair market value far below the taxpayer's alleged purchase price. The Tax Court ruled that the claimed sale price far exceeded fair market value, that a sale had not

occurred, and that the transaction lacked economic substance. Depreciation deductions were disallowed entirely.

On similar facts in *Zirker v. Commissioner*, 87 T.C. 970 (1986), similar conclusions were reached. In *Zirker*, however, the Court cited *Grodt & McKay Realty* for the proposition that since no sale had occurred, "it follows that petitioner's 'correct' adjusted basis in the cattle is zero." 87 T.C. at 978. The Court then concluded that an overvaluation penalty would be imposed under section 6659 and fixed the penalty percentage at 30 percent, viewing the overvaluation as having exceeded 250 percent. *Zirker* was relied on by the Eighth Circuit to impose an overvaluation penalty in still another case involving a claimed purchase of breeding cattle, *Massengill v. Commissioner*, 876 F.2d 616 (8th Cir. 1989).

It is fairly questionable whether what occurred in these cases was a "valuation overstatement." What indisputably happened is that the Tax Court ruled that no sale had occurred. In one sense, the taxpayers had "overvalued" by claiming a high value for an asset that the Tax Court ruled they had not bought at all. Yet, in another sense, these were not cases of taxpayers selecting an unduly high value; rather, the taxpayers were rebuffed in their claims that any purchase at all had occurred. To say that a taxpayer has a zero basis in an asset he is found not to have acquired seems strained. Yet the appropriateness of the penalty seems more justified if one considers the alternative arguments of the Commissioner in *Grodt & McKay Realty*, arguments typically made in tax shelter disputes. Had the Commissioner been confined to his fallback position that the taxpayer's basis for depreciation was fair market value, a value far below his claimed purchase price, it would

have been entirely sound to say that the asset had been "overvalued" and to impose the section 6659 penalty. If the Commissioner is more successful and persuades the Court to disregard not only the nonrecourse notes but the entirety of the purchase price, thereby lowering the "price" down not only to fair market value but all the way to zero, should the Commissioner's success have the perverse effect of sparing the taxpayer the overvaluation penalty?

We are inclined to accept the view of the Tax Court in this and the prior cases and of the Eight Circuit in *Massengill* and deem the penalty applicable. Indeed, ours is a stronger case for the penalty than the cattle cases, because, while the Commissioner disputes that the computer transaction has sufficient economic substance to warrant deductions for depreciation and interest, he does not contend that Gilman did not make a purchase. We acknowledge that applying the penalty somewhat strains the natural reading of the statutory phrase "valuation overstatement." And where the taxpayer's basis has been reduced to zero, it is somewhat odd to apply a provision that scales the penalty rates to the percentage of overvaluation. The percent of "overvaluation" above zero is infinite, which is literally more than 250 percent, the level at which the 30 percent penalty rate begins to apply. But arguably the overvaluation in a sham transaction is different in kind, not merely degree. On the other hand, application of the section 6659 penalty surely reenforces the Congressional objective of lessening tax shelter abuse. Moreover, we note that when Congress recodified and somewhat simplified penalty provisions in 1989 by creating a general "accuracy-related penalty," Pub. L. 101-239, § 7721(a), 103 Stat. 2395, 2395-97 (1989), to be codified at 26 U.S.C.

§ 6662, *see* 26 U.S.C.A. § 6662 (Supp. 1991), it retained the concept of a "valuation overstatement" as an example of a circumstance warranting the revised penalty, *see* subsections 6662(b)(3), (e), and made no change to preclude application of the penalty to tax shelter transactions like Gilman's where an alleged purchase price is totally disregarded as a basis for depreciation deductions.

Gilman further argues that even if there was a valuation overstatement, the tax deficiency was not "attributable" to it, as required by section 6659(a). Gilman relies primarily on *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988), in which the taxpayers took depreciation deductions on property with a highly inflated basis. They failed, however, to put the property into service in the tax year for which they were claiming the deductions. The deductions were denied, creating an underpayment of tax. The Court concluded that there should be no section 6659 penalty because the underpayment was not attributable to the valuation overstatement, but rather to the taxpayer's failure to comply with the depreciation regulations requiring the property to be placed into service. *See also Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990) (imposition of section 6659 penalty reversed, based on *Todd*). Applying this interpretation of section 6659 to his case, Gilman argues that where the underpayment derives from the disallowance of the transaction (*i.e.*, non-recognition of the transaction for tax purposes), then the underpayment is not attributable to an overvaluation.

Again, we agree with the Tax Court and with the Eighth Circuit, which has concluded that "[w]hen an underpayment stems from disallowed depreciation

deductions or investment credit[s] due to lack of economic substance, the deficiency is attributable to overstatement of value, and subject to the penalty under section 6659." *Massengill*, 876 F.2d at 619-20. The lack of economic substance was due in part to the overvaluation, and thus the underpayment was attributable to the valuation overstatement. While the Tax Court did not explicitly discuss the question of whether the purchase price paid by Gilman was fair, a premise of the Court's conclusion is that at the time Gilman entered the transaction, he could not reasonably expect a profit independent of taxes and that the purchase price of $3 million was more than the computers were worth. In that way, the overvaluation of the computer equipment contributed to the Court's conclusion that the transaction lacked economic substance and was a sham.

Perhaps recognizing that he was not likely to succeed on his broad argument that underpayments arising out of transactions disallowed for lack of economic substance are not attributable to valuation overstatements, Gilman suggests a more refined approach. He urges us to evaluate the relationship between each disallowed tax item and the overvaluation and determine whether the specific disallowed item relied on the overvaluation. We need not do so. Gilman's various disallowed tax items, for example his depreciation and interest deductions, were all disallowed because the transaction was a sham. Where a transaction is not respected for lack of economic substance, the resulting underpayment is attributable to the implicit overvaluation. A transaction that lacks economic substance generally reflects an arrangement in which the basis of the property was misvalued in the context of the transaction. While this interpretation of underpayment "attributable to a valuation over-

statement'' represents a less common application of section 6659, we believe it comprehends the tax return representations that Congress intended to penalize.

III. Imposition of a penalty rate of interest

Under section 6621(c)(1) interest on tax deficiencies is levied at a rate of 120 percent of the normal rate where the underpayment is attributable to a "tax motivated transaction." Tax motivated transactions include valuation overstatements. Section 6621(c)(3)(A). Since Gilman's computer equipment transaction involved a valuation overstatement, the penalty interest rate of section 6621(c) applies.

Conclusion

For the foregoing reasons, the decision of the Tax Court is affirmed.

UNITED STATES TAX COURT
Washington, D.C. 20217

Docket No. 15585-87

HOWARD GILMAN,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court as set forth in T.C. Memo. 1989-684 served on December 28, 1989, it is

ORDERED AND DECIDED that there are deficiencies in income tax due from petitioner for the taxable years 1980 and 1981 in the amounts of $171,680 and $329,555, respectively, and an addition to tax for the year 1981 in the amount of $98,867. All of the deficiencies for 1980 and 1981 constitute substantial underpayments attributable to tax-motivated transactions within the meaning of Internal Revenue Code section 6621(c), formerly section 6621(d).

(Signed) CHARLES E. CLAPP II
Charles E. Clapp II
Judge

Entered: JAN - 3 1990

UNITED STATES TAX COURT
Washington, D.C. 20217

Filed December 28, 1989
Docket No. 15585-87

T. C. Memo. 1989-684

HOWARD GILMAN,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Robert H. Aland, *Frederick E. Henry*, *Brett R. Keenan*, for the petitioner.

Laurence A. Hoch, *Drita Tonuzi*, and *Roland Barral*, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CLAPP, *Judge*: Respondent determined deficiencies in petitioner's Federal income tax and additions to tax as follows:

		Additions to tax	
Year	*Deficiency*	*sec. 6659*[1]	*sec. 6621(c)*
1980	$171,680	—	applicable
1981	329,555	$98,867	applicable

1 All section references are to the Internal Revenue Code of 1954, as amended and in effect for the years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

Petitioner has conceded certain issues regarding the 1981 taxable year. The remaining issues are (1) whether petitioner's purchase of certain computer equipment should be respected for Federal income tax purposes; (2) whether petitioner purchased and leased the equipment for profit within the meaning of section 183; (3) whether petitioner was at risk under section 465 with respect to his indebtedness; (4) whether petitioner used the appropriate method of depreciation; (5) whether petitioner's underpayment of tax is attributable to a valuation overstatement within the meaning of section 6659; and (6) whether the transaction was tax motivated within the meaning of section 6621(c) (formerly section 6621(d)).

FINDINGS OF FACT

Some of the facts are stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference. Petitioner resided in New York City when he filed his petition.

During 1980, petitioner was chairman of the board, chief executive officer, and sole stockholder of Gilman Paper Company, which had approximately 2,500 employees and annual sales of several hundred million dollars.

Prior to the transaction in issue, Disko Leasing GmbH (Disko) purchased certain computer equipment (the equipment) that it leased to end users located in West Germany. These leases ended between mid-1982 and early 1985. The equipment consisted of a Model 370-158-U33 and a System 34 manufactured by IBM Deutschland GmbH (IBM); two Systems 2950 manufactured by ICL Deutschland International Computers GmbH (ICL); a Model 62/35 manufactured by Honeywell Bull AG (HB); and a Basic/Four 730 manufactured by MAI International GmbH (MAI). Disko borrowed the funds to make the purchase from Dresdner Bank, which acquired the right to receive the rents payable to Disko by the lessees and also obtained title to the equipment as security for payment of the loans. This title would be automatically transferred to Disko upon full payment of the

loans. Dresdner Bank's retention of legal title placed it in essentially the same position as the holder of a mortgage. The equipment was purchased on the following dates for the following prices:

Equipment	*Purchase Date*	*Cost Deutschemarks*	*Cost Dollars*
IBM 370/158	8/01/78	4,245,164	2,165,900
ICL 2950	11/16/79	1,121,171	572,026
ICL 2950	03/21/80	1,211,606	618,166
IBM Sys. 34	04/10/80	671,255	342,462
HB 62/35	12/17/79	559,569	285,494
MAI Basic Four	03/14/80	233,000	118,878
Total Cost		8,041,765	4,102,926

On December 30, 1980, Disko sold its interest in the equipment to Equilease B.V. (Equilease) subject to the end-user leases and Dresdner Bank's security interest in the equipment. Equilease was an unrelated Netherlands corporation that intended to resell the equipment to individuals. The terms of purchase were a downpayment of DM 2,266,611 and semiannual installment payments of DM 4,190,737. Disko and Equilease also entered into lease agreements for terms of 9 years, under which Disko leased the equipment from Equilease for aggregate semiannual rental payments of DM 4,190,737. Disko remained obligated to make its lease payments to Equilease even if an end user defaulted in its underlying lease payments to Disko. If Disko defaulted on its lease payments, Equilease had the right to terminate the lease agreements with Disko and take possession of the equipment. Disko was responsible for maintenance, repairs, taxes, and insurance on the equipment. Upon written notice to Equilease, Disko could replace the equipment with similar computer equipment of equal fair market value.

Equilease also entered into security agreements with Disko pursuant to which Equilease assigned to Disko its interest in the computer equipment as security for its payment of the semiannual installments on the loan. If Equilease should default on the loan, its right to obtain legal title to the equip-

ment would revert to Disko, which would have the right to terminate its lease agreements with Equilease.

In November 1980, Joel Mallin (Mallin), an equipment broker who had put together hundreds of equipment leasing deals, informed petitioner's attorney, Bernard D. Bergreen (Bergreen), that Equilease was in the process of purchasing a substantial amount of computer equipment from Disko. Mallin prepared a series of financial schedules or "spreadsheets" which showed the financial and tax consequences of the transaction. There were only minor variations from one spreadsheet to another. The December 27 version of the spreadsheet (the only version introduced into evidence), Appendix A, was based upon the assumptions that the selling price of the equipment would be $3 million, and at the end of the lease the equipment would have a net residual value (after subtracting a 10-percent remarketing fee) of $600,000, or 20 percent of the selling price. This spreadsheet showed that petitioner would receive a $382,150 cumulative net benefit, including tax benefits, from the transaction assuming a 5-percent after tax return on "use-of-money." This cumulative net benefit would be primarily due to petitioner's investment of the savings from the front-loaded tax benefits. Although the spreadsheet does not show this calculation, the use of the same methodology would have given petitioner a cumulative benefit of $142,150 even if the equipment had a zero residual value. Except for the spreadsheets, neither Mallin nor his staff prepared any documents, offering memoranda, descriptive brochures, or other promotional materials with respect to any of the proposals presented to Bergreen or petitioner. Petitioner first saw a preliminary copy of the spreadsheet in the first week of December 1980.

After discussing the proposed transaction with Bergreen and inspecting several versions of the spreadsheet, petitioner decided on December 10 or 12 to proceed with the purchase. The transaction was structured so that Equilease first sold the equipment to Aardan Leasing Corporation (Aardan), an unrelated Delaware corporation, for $2,992,500. This sale occurred on December 31, 1980. The same day, Aardan sold the equipment to petitioner for $3 million. Aardan was obli-

gated to make payments to Equilease on the same dates and essentially in the same amounts that petitioner made to it, with the exception that Aardan retained a portion of the downpayment that it received from petitioner.

Petitioner paid Aardan $45,000 in cash and gave Aardan an interest-bearing limited recourse promissory note in the principal amount of $2,955,000 that was secured by the equipment. Part of the interest payments on the note due in 1981 and 1982 were evidenced by separate short-term promissory notes, which themselves bore interest, due on April 30, 1981 and January 31, 1982. Pursuant to an arrangement entered into prior to closing, Aardan assigned the short-term notes to Intercontinental Monetary Corporation, an unrelated corporation, on the date of closing. The short-term notes were secured by letters of credit issued on January 15, 1981, by petitioner's bank, Morgan Guaranty Trust Company. Petitioner leased the equipment to Equilease for a term of 9 years, with Equilease responsible for maintenance, repairs, taxes, and insurance. Petitioner's obligations and expectations were as follows:

	1980	*1981*	*1982*	*1983-89*
Downpayment on 12/31/80	$45,000.00	—	—	—
Annual Payments				
Interest on 12/31/80	1,641.67	—	—	—
Monthly Interest of $33,000	—	$396,000	—	—
Monthly Interest of $34,250	—	—	$411,000	—
Monthly Interest and Principal of $65,619.32	—	—	—	$787,432/yr.
Interest on 4/30/81 evidenced by $195,000 short-term note with interest of $12,452	—	207,452	—	—
Interest on 1/31/82 evidenced by $180,000 short-term note with interest of $37,145	—	—	217,145	—
Total Payments	$46,641.67	$603,452	$628,145	$787,432/yr.
Rent Receipts	$1,641.67	$404,400	$419,400	$795,832/yr.

Petitioner made total lump-sum payments of $469,597 during 1980 through 1982, consisting of the $45,000 downpayment on December 31, 1980, the $207,452 payment on the first short-term note on April 30, 1981, and the $217,145 payment on the second short-term note on January 31, 1982. All of these lump-sum payments, plus considerably more, were recovered through tax benefits from the transaction on petitioner's next tax returns. Petitioner also would receive an $8,400 net annual cash flow in the years 1981 through 1989 from the excess of rents over note payments, and the right to the equipment's net residual value at the end of the lease.

Pursuant to a marketing agreement between petitioner and Equilease, Equilease would market the equipment at the end of the lease. Petitioner agreed to pay Equilease a fee equal to 10 percent of the proceeds from the sale or re-lease of the equipment reduced by reasonable expenses (including appraisal costs, repossession costs, packing and shipping costs, and attorney fees). In the alternative, petitioner, at his sole discretion, could elect to pay Equilease "an amount equal to such fees customarily charged (at the time of the applicable marketing) by recognized concerns performing similar services in the computer leasing industry."

Equilease ordered and paid for an appraisal of the equipment by Diebold Deutschland BmbH (Diebold), a West German computer consulting firm and the only appraiser that Equilease used in Germany. The appraisal was dated "As December 31, 1980" and was received by petitioner in January 1981. The appraisal, prepared by Fritz R. Muller (Muller), an employee of Diebold, was just over one typewritten page. The appraisal stated that (1) the $3 million selling price of the equipment was fair market value; (2) a reasonable estimate of residual value at the end of the lease was $600,000, or 20 percent of the selling price; (3) the equipment would have a useful life of more than 11-1/2 years from December 31, 1980; and (4) the rental payments represented a fair market value rental over the term of the lease. The appraisal contained no explanation of the manner in which Muller reached his conclusions other than the statements that he "examined * * * [materials related to the transaction] and conducted

such investigations as we believe appropriate under the circumstances * * *" and he based his conclusions upon "said investigations and our experience in the field of computer leasing and computer related equipment * * *."

OPINION

The issues are (1) whether petitioner's purchase of certain computer equipment should be respected for Federal income tax purposes; (2) whether petitioner's purchase and lease of the equipment was engaged in for profit within the meaning of section 183; (3) whether petitioner was at risk under section 465 with respect to his indebtedness; (4) whether petitioner used the appropriate method of depreciation; (5) whether petitioner's underpayment of tax is attributable to a valuation overstatement within the meaning of section 6659; and (6) whether the transaction was tax motivated within the meaning of section 6621(c) (formerly section 6621(d)). Petitioner bears the burden of proof on all issues. Rule 142(a).

I. *Whether purchase respected for Federal tax purposes*

As we said in *Larsen v. Commissioner*, 89 T.C. 1229, 1251-1252 (1987):

> Taxpayers are generally free to structure their business transactions as they please, though motivated by tax-reduction considerations. *Gregory v. Helvering*, 293 U.S. 465 (1935); *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 196 (1983), affd. on this issue 752 F.2d 89 (4th Cir. 1985). However, it is well settled that a transaction entered into solely for the purpose of tax reduction, and which is without economic, commercial, or legal purpose other than the expected tax benefits, is an economic sham without effect for Federal income tax purposes. *Frank Lyon Co. v. United States*, 435 U.S. 561, (1978); *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 196; *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1243 (1981). Nevertheless,

the existence of tax benefits accruing to an investor does not necessarily deprive a transaction of economic substance. *Frank Lyon Co. v. United States, supra*; *Estate of Thomas v. Commissioner*, 84 T.C. 412, 432 (1985). In the sale and leaseback context, we set forth a standard that the non-user-owner recipient of tax benefits must specifically establish that the entry into the transaction was motivated by business purpose to justify the form of the transaction, and that the transaction was supported by economic substance. *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 201-203.[12] In *Rice's Toyota World, Inc.*, we stated that the tests developed under the sham transaction doctrine are applied to determine whether a threshold level of business purpose or economic substance is present. *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 196.[13]

This Court has had numerous opportunities to consider the validity for Federal income tax purposes of computer equipment sale-leasebacks. In each case, our conclusions regarding business purpose and economic substance were inherently factual. See *Larsen v. Commissioner*, 89 T.C. at 1252-1253. It is difficult to draw a precise line of demarcation between valid and invalid transactions. *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 297 (1983), affd. on this issue 752 F.2d 89 (4th Cir. 1985).

Petitioner bears the burden of proof, as respondent's determination is presumptively correct. Rule 142(a). We will separately consider whether petitioner has shown either that he was motivated by a business purpose or that the transaction had economic substance.

12 *Carlson v. Commissioner*, T.C. Memo. 1987-306.

13 The presence of business purpose does not entitle a transaction to be recognized for Federal tax purposes where objective indicia of economic substance indicating a realistic potential for economic profit are not manifest. *Cherin v. Commissioner*, 89 T.C. 986 (1987).

A. *Business purpose*

The business purpose inquiry concerns petitioner's motive for entering the transaction. *Rice's Toyota World, Inc. v. Commissioner, supra* at 92. If petitioner had a business purpose other than obtaining tax benefits, he would not have committed himself to the transaction until he satisfied himself that there was a reasonable possibility that the residual value of the equipment would be great enough to offset his substantial investment in the equipment.

Petitioner testified that he decided to purchase the equipment based on the figures on the spreadsheet and the advice and explanations being given him by Bergreen. He stated that he relied on the Diebold appraisal and expected to make a profit independent of tax benefits because of the $8,400 annual cash flow and the residual value. He did not consider getting a second appraisal because Diebold was well recognized and involved in the German market.

We conclude for several reasons that petitioner did not have a business purpose other than obtaining tax benefits. First, the only residual value figure that he saw prior to the transaction was the one on the spreadsheet. The 20-percent net residual value figure that appeared on the December 27 version of the spreadsheet apparently also appeared on the draft of the spreadsheet that petitioner saw in the first week of December 1980 because there were only minor variations from one spreadsheet to another. Mallin, the promoter, testified that he inserted the 20-percent figure into the spreadsheet after Equilease advised him that the Diebold appraisal was going to show such a residual value. Since petitioner first saw the spreadsheet in early December, this would mean that the Diebold appraisal would have had to be made by the first week of December. Muller testified, however, that he was not contacted to perform the Diebold appraisal until sometime in December 1980. We, accordingly, conclude that the residual value figure on the spreadsheet was not based upon an appraisal but instead was Mallin's estimate of residual value. We also note that the 20-percent figure on the spreadsheet represented residual value after subtraction of the 10-percent

marketing fee and expenses of sale, while Diebold's 20-percent figure represented residual value before subtraction of the marketing fee and expenses. This is further evidence that the spreadsheet figure was not based upon an appraisal but instead was Mallin's estimate. If petitioner had a business purpose, he would not have relied upon the promoter's estimate of residual value as he did.

Second, petitioner asserts that his attorney, Bergreen, received an oral appraisal prior to the closing, but this assertion is not supported by the evidence. Bergreen admitted on cross-examination that the oral appraisal actually was received by an associate in his law firm. The associate then testified that he did not receive an oral appraisal from Diebold, but rather an oral confirmation from Equilease that an appraisal had been arranged and would be forthcoming. The associate also testified that he did not know whether Diebold had appraised the equipment when the closing took place on December 31, 1980. Accordingly, we conclude that neither petitioner nor any of his advisors had received a written or oral appraisal prior to the time that petitioner committed himself to the transaction.

Third, we attach little importance to the written appraisal petitioner received in January 1981. Petitioner asserts that he ensured that this appraisal would be forthcoming by withholding the letters of credit until after the appraisal was received. This argument has several flaws. First, it appears that Aardan's sale of the short-term notes to International Monetary Corporation had no effect upon Equilease, so we do not understand how petitioner could ensure Equilease's delivery of the appraisal by withholding the letters of credit from Aardan. Second, the parties stipulated that Aardan sold the notes to International Monetary Corporation on December 31, 1980. Any incentive that Aardan had to ensure delivery of the letters of credit would have terminated on that date. Third, petitioner asserts that his attorneys prepared "the legal documents * * * in meticulous detail," which suggests the documents covered all matters which petitioner thought were important. Since the documents did not provide

petitioner with the right to receive an appraisal, we conclude that petitioner was not concerned with receiving an appraisal.

Fourth, we question whether petitioner's efforts to receive a written appraisal are even relevant to the issue of business purpose. If petitioner had a business purpose, he would have wanted to determine the profitability of the transaction before, rather than after, committing himself to the transaction. Once petitioner committed himself to the transaction, an appraisal would have been of little value unless the receipt of a satisfactory appraisal had been a condition of the transaction. It was not, so we conclude that his belated efforts to receive a written appraisal do not indicate a business purpose.

Fifth, we note that the Diebold appraisal was long on conclusions, but short on reasoning. We have previously noted that "a listing of unsupported conclusions as to the Equipment's value" is "not a document worthy of reliance." *Mele v. Commissioner*, T.C. Memo. 1988-409. We question whether an experienced businessman with a business purpose would have made a $3-million purchase on the basis of such an appraisal, even when done by a reputable appraisal firm, especially when the appraisal was arranged by the seller.

Finally, we address several other arguments made by petitioner. First, he points to the thorough advice he received with respect to the transaction and the care with which he executed the various documents. Citing *Levy v. Commissioner*, 91 T.C. 838, 855-856 (1988), he argues that such care is evidence of business purpose. No amount of such care, however, can establish a business purpose when there is little evidence that the transaction was motivated by nontax considerations. Second, petitioner asserts that he reasonably relied upon Equilease's representation that the appraisal would be satisfactory. However, the associate of Bergreen who handled the transaction admitted that he did not know whether Diebold had appraised the equipment before closing occurred. Thus, there was no basis on which to rely upon the representations of Equilease. Third, petitioner says that Equilease had been advised by its attorneys of possible securities law problems if the appraisal were not reasonable. The implication is that petitioner could be assured of a satisfac-

tory appraisal since such an appraisal was in the interest of Equilease. However, the transaction was not conditioned upon the receipt of a satisfactory appraisal, and except for some vague testimony by Mortimer Wimpie (Wimpie), who managed Equilease during 1980, there is no evidence that Equilease would have been willing to cancel the transaction if the appraisal had not been satisfactory to petitioner. Fourth, Bergreen and his associate testified that in December 1980, they retained a lawyer in Germany who "confirmed" both the Diebold appraisal and a residual value forecast by the managing director of Disko. We are unable to attach any weight to this sketchy testimony regarding the services of this lawyer.

Petitioner's lack of interest in the residual value of the equipment is consistent with the nature of the transaction. The spreadsheet showed that petitioner would receive by the end of 1989 a $382,150 cumulative net benefit from the transaction at a 5-percent aftertax rate of return. This cumulative net benefit primarily resulted from the investment of up-front tax benefits and not from the transaction itself. Although the spreadsheet does not show this calculation, petitioner would have had a $142,150 cumulative net benefit at the end of 1989 even if the equipment had no residual value. Petitioner would have received this benefit at no cost as each year's cumulative net benefits exceeded that year's investment or, in later years, net tax liability due to the transaction. Thus petitioner, due to tax benefits, had no investment in the transaction and his lack of interest in the residual value is understandable. If petitioner had really been looking to the transaction without tax benefits to return his cash outlays of $469,597, he would have been much more interested in residual values. The $8,400 per year of excess rent over principal and interest payments was a mere pittance that could not produce a business purpose in the mind of a reasonably astute businessman. Beyond the $8,400, in the years after 1982 the transaction was a wash that was probably handled by a series of bookkeeping entries.

We conclude that petitioner was not motivated by a business purpose other than tax benefits.

B. *Economic substance*

Petitioner's transaction "has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits." *Gefen v. Commissioner*, 87 T.C. 1471, 1490 (1986). We analyze the transaction as a prudent investor would have. *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 209 (1983), affd. on this issue 752 F.2d 89 (4th Cir. 1985). We place some weight upon the taxpayer's subjective statement as to his nontax motive, but far greater emphasis upon objective facts demonstrating a realistic potential for profit. *Cherin v. Commissioner*, 89 T.C. 986, 992 (1987).

The instant transaction was one in which petitioner made an investment of \$469,597 and in return would receive \$8,400 per year and the residual value of the equipment. Petitioner's net investment thus was \$393,997 (\$469,597 minus (9 × \$8,400)). Since Equilease was entitled to retain 10 percent of the residual value, petitioner would earn a profit only if the residual value exceeded \$437,774, or 14.6 percent of the original purchase price. Accordingly, petitioner must show that in 1980 a prudent investor could have concluded that there was a realistic opportunity that the residual value of the equipment at the end of the lease would have exceeded 14.6 percent of the original purchase price.

Both parties rely on expert testimony to establish the residual value of the equipment at the end of the lease. We are not bound by the opinions of such experts when their opinions are contrary to our own judgment. *Chiu v. Commissioner*, 84 T.C. 722, 734 (1985). In determining residual value, "the question is not who was correct in predicting the actual residual value of the computer equipment * * * [at the end of the lease]; rather, the question is what was reasonable to believe * * * [at the time of purchase] with respect to what the residual value of the computer equipment would be * * * [at the end of the lease]." *Gefen v. Commissioner*, 87 T.C. at 1491 n. 10.

Petitioner presented two expert witnesses who testified that the residual value would be 20 percent or greater. Petitioner's

first expert was Muller, the appraiser who did the original Diebold appraisal. Muller has been managing director at Diebold since 1986. Rather than preparing another appraisal, Muller explained his 1980 appraisal. He said that appraisal was based upon various information, including a "computer census of installations" which indicates the life of about 12,000 computer installations, price information collected from leasing companies and brokers, information from market studies, and information from about 1500 other studies done each year. Muller did not, however, present any of this information in his expert report.

Muller explained that his conclusion that the residual value would be 20 percent was based upon the assumption that—

> price would be reduced to half about every four years. This assumption was based on experiences in the past.
>
> * * *
>
> Based on the fact that at the end of 1980 new products had been announced, a greater depreciation was assumed for the period 1980/1981. From 1981 through 1985 an almost straight line depreciation was assumed which would flatten out toward the end of the evaluation period.
>
> For such development it was assumed that even after the end of 1989 the respective equipment would have a scrap value (gold, copper wires, cables, boards) of about 10% to which a value of a further 10% considering its possible use had to be added.
>
> Taking all these factors and considerations into account, I arrived at the table of declining depreciation in value as attached to the Report.

Muller concludes, as one might expect, that his 1980 appraisal was accurate at the time it was issued.

We find Muller's expert report to be confusing and difficult to follow. His testimony at trial did not clarify his report. In his original appraisal, Muller mentioned a useful (or economic) life of 11-1/2 years from the date of petitioner's

purchase. However, in the expert report he presented at trial, he stated that at the "end of the seventies and the beginning of the eighties a useful life of ten years was assumed for economic feasibility studies." On the next page he states that the "lifecycle of the computer generation in the 60ies and 70ies made it possible that the usage of computer systems came up to 11 years and longer." Testifying at trial, he stated that at the time of the appraisal "we were using computers about 8 years, 10 years, 12 years or so." These various useful life figures not only differ from each other, but it is not entirely clear whether they are measured from the date of introduction, the date of original purchase, or the date of petitioner's purchase of the equipment. In any event, the useful lives of the equipment would not end more than a year or two beyond the termination of the 9-year leases. Any rentals received after the termination of the leases and before the end of the useful lives would be low, in part because the equipment would be on the verge of obsolescence and would bring a low rental rate. In fact, we do not even know that the equipment could be rented as petitioner offered no evidence that Disko intended to, or did, lease the equipment to end users after the original user leases expired between mid-1982 and early 1985. This may mean that Disko believed that the equipment would be obsolete years before petitioner received the right to the residual value. We conclude that Muller's own assumptions regarding useful life result in a minimal residual value.

We also question Muller's 10-percent figure for scrap value. Muller explained that he got this figure from the managers in charge of maintenance at the computer manufacturers. Muller now admits that actual scrap value "was considerably lower than the assumed 10% of the original value * * * ." Muller explained that his estimate of scrap value was too high "because new technology brought electronic components and their implementation in compressed form." It is unclear, however, why "implementation in compressed form" would affect the value of components such as gold, and why "implementation in compressed form" would not have been foreseen in 1980 by a computer expert who

knew that computer components were becoming smaller. It appears to us that Muller simply received erroneous information regarding scrap value, and in 1980 the scrap value could not have been reasonably expected to be anywhere close to 10 percent. We note that S. Paul Blumenthal, one of respondent's experts, estimated scrap value to be less than 1 percent.

We also do not understand how Muller can conclude that residual value equals the sum of a 10-percent scrap value and a 10-percent value from continued use. One cannot simultaneously scrap a piece of equipment and make further use of it.

We conclude Muller's residual values are not based on sound and logical reasoning. We are left with the impression that in 1980 Muller was asked to provide an appraisal which would support the 20-percent residual value on Mallin's spreadsheet. He did so, and his expert report at trial was an attempt to justify that earlier appraisal.

Petitioner's second expert was Barry T. Cross (Cross). Cross works for Computer Resale Brokers Limited (CRB), a United Kingdom corporation which, according to its brochure, offers the "most comprehensive range of services including buying and selling computer equipment, brokerage and agency services for equipment disposal and acquisition." CRB does business in many countries, including Germany.

Cross has worked for CRB since 1969, initially as international sales director and since 1973 as managing director (chief executive officer). His expert report states that as managing director he is "responsible for overseeing the business of CRB in general * * * and to ensure that the company projects an image of professionalism and trading integrity." Cross also says his "primary function as Managing Director of CRB is to stay current on market trends and market changes so that CRB can advise its major clients of the way it believes residual values of their computer equipment will change over the forthcoming years. These forecasts by CRB are used by our clients in their own forward planning of their major computer acquisitions."

Cross testified that the equipment would have had "an average remaining useful life of approximately 12-1/2 years as of 31 December 1980." He says he would have estimated the residual value to be 26 percent, or $780,000. We question Cross's appraisal for several reasons.

First, Cross presents no substantiation for any of his figures. He claims to provide residual value forecasts to his firm's customers, yet there is no evidence that his appraisal was based upon any of the forecasts he made around the time of petitioner's purchase of the equipment. Nor, unlike Muller, does he present any theory which describes how computer prices decline over time.

In addition, Cross apparently based his appraisal upon his perception of the effects of various developments in computer technology upon computer prices. We question, however, the weight that he attached to certain developments in technology. For example, he said that the announcement of the IBM 4300 series in 1979 had no effect upon the residual value of the IBM 370/158. However, in several cases we have noted that the announcement of the IBM 4300 series had a drastic effect on the fair market value and future residual value of mainframe computer systems such as the IBM 370/158. In *Larsen v. Commissioner*, 89 T.C. 1229, 1246 (1987), we said "the mainframe market was devastated following the introduction of the 4300 Series in January 1979 * * *." See also *Coleman v. Commissioner*, 87 T.C. 178, 198 (1986), affd. without published opinion 833 F.2d 303 (3d Cir. 1987); *Gefen v. Commissioner*, 87 T.C. 1471, 1487 (1986); *Ockels v. Commissioner*, T.C. Memo. 1987-507; and *Greenbaum v. Commissioner*, T.C. Memo. 1987-222. Cross also admitted on cross-examination that the IBM 308X computers competed with the 370/158. However, his report makes no reference to the IBM 308X computers. Petitioner explains that the IBM 4300 and 308X were too new to affect the European used computer market in 1980. However, their newness in 1980 does not mean that they would have no effect upon residual values 9 years later. We believe that the constant advances in the state of the art, including these computers, should have been given more attention by Cross. Had he

done so, we believe he would have arrived at substantially lower residual values.

We also question Cross's statement that he "would presently [in June 1988] estimate the residual value of the Equipment as of 31 December 1989 to be in excess of the US$600,000 estimate contained in [Muller's] Report." We do not understand anyone connected with this case, except Cross, to claim that the residual value at time of trial was anywhere near the $600,000 value in Muller's original appraisal letter. This casts further doubt upon Cross's ability to accurately forecast residual values.

We conclude that Cross's conclusions regarding residual value are not credible. For example, he assumed a 12-1/2 remaining useful life for equipment that not only was used but had been introduced a number of years previously. In addition, he ignores the effect of the superior technology that was already on the market. If Cross had been less result-oriented, we believe his residual value figure would have been nominal.

Before turning to the testimony of respondent's experts, we note that petitioner argues that a portion of his expected return from the investment would come from currency changes and inflation, and this would cause residual value to be greater than forecast in 1980. However, petitioner has presented no evidence that a reasonable investor in 1980 would have believed that the German Mark was more likely to increase than decrease in value. With regard to a return from inflation, we note that Muller (and presumably Cross) calculated future residual values by reference to the past trend in residual values. Since inflation affected that past trend, the return from inflation was incorporated in the appraisals.

Respondent's experts were S. Paul Blumenthal (Blumenthal) and Jonathan C. Moody (Moody), both employees of American Technology Appraisal Service. Blumenthal is senior vice president and has been involved in thousands of computer appraisals. Prior to this case, he had several times appraised computer equipment located in Europe. Moody is vice president and manages a staff which produces appraisal reports and market research reports on the pricing of com-

puter equipment. Prior to this case, he had not been involved in the appraisal of computer equipment in Europe.

Although Blumenthal and Moody have relatively little experience appraising European computer equipment, they are very familiar with the American computer market. Their report established American residual values by drawing upon appraisals done by their company in 1980. A March 1980 appraisal had forecast the IBM 370-158 would have minimal value by 1984, and virtually no value by 1985. This report discussed the effect of the IBM 4300 upon the residual price of the IBM 370. A September 1980 appraisal had forecast the IBM System/34 would have minimal value by 1985, and zero value by 1986. Blumenthal and Moody had no contemporaneous appraisal for the other equipment purchased by petitioner. However, the performance of the IBM 4300 was equal to or greater than that of the other equipment, and thus residual values of the 4300 would provide an accurate, or even optimistic, view of the residual value of the other equipment. A May 1980 appraisal of the IBM 4300 indicated that the 4300 would not have any residual value after 1988.

Blumenthal and Moody had to adjust these American residual values for the differences between the American and European markets. Their report explained that the improvement of communications, and the expansion of computer use worldwide, had minimized differences between the European and American computer markets. A survey of the records of various international computer leasing firms and a review of various publications indicated that European new computer prices tended to be 150 percent of the American price, while European used computer prices tended to be between 75 and 125 percent of American prices. Blumenthal and Moody explained that this difference between European and American prices was unlikely to widen because arbitragers would ship equipment between the two markets if the difference between American and European prices were greater than the costs of purchasing equipment in one market and selling in the other. In fact, Cross testified that American computer brokers were shipping used IBM 370's to Europe in 1980.

Based upon their contemporaneous appraisals in the American market and taking into account the differences between European and American prices, Blumenthal and Moody concluded that none of petitioner's equipment would have any residual value in 1989. We were impressed with Blumenthal's expert testimony, and with the report that he and Moody prepared. Their discussion of the computer market during the relevant time period is complete and draws upon information in many respected computer publications. For example, the report mentions an August 1980 article in a European computer publication that comments upon "swift drops in residual values caused by rapid technological progress * * *." Blumenthal and Moody also drew upon their contemporaneous appraisals done in 1980, and provided copies of their appraisals. This is unlike Muller and Cross, who provided little support for their residual values.

We have studied all of the expert reports, listened to the experts on the witness stand and reviewed their testimony, and applied our own knowledge and experience. We conclude that respondent's position with respect to residual value is much more reasonable than petitioner's. Common sense tells us that Muller and Cross were too optimistic about the remaining useful lives of the equipment. They avoided any substantial consideration of the effect of the introduction of new equipment such as the IBM 4300 series, and the known rapid obsolescence in the field due to constant technological change. Muller focused on IBM 370 computer equipment, which was announced in the early seventies, with upgraded versions being announced in the following years. Such equipment was hardly state of the art when purchased by Disko in 1978. Petitioner did not purchase the equipment for another 2 years. We do not find it reasonable to conclude that such equipment would have any measurable residual value 9 years after petitioner's purchase.

We find the appraisals of respondent's experts to be sufficiently more convincing than those of petitioner's experts and conclude that in December 1980 a prudent investor would have concluded that the equipment would have only a nomi-

nal residual value in December 1989. *Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. 441, 452 (1980).

A final piece of evidence regarding residual value was furnished by Wimpie, the senior president and director of Equilease in 1980, and the individual who managed Equilease during the years in issue. Wimpie testified that Disko was surprised to be able to sell the equipment to Equilease. He said that Disko "derived whatever profits they planned to derive from those leases. The monies that Equilease paid was over and above what their anticipated income on the transactions were." This testimony suggests that Disko believed that the equipment had little or no residual value at the end of the end user leases.

C. *Conclusion*

We conclude that a reasonable investor would not have believed that petitioner's transaction offered a reasonable opportunity for economic profit exclusive of tax benefits. Accordingly, the transaction had no economic substance. Since petitioner also lacked a business purpose, the transaction will not be respected for Federal tax purposes. Petitioner's depreciation and interest deductions therefore are disallowed.

Putting aside the business purpose and economic substance requirements and just focusing on the nature of the transaction, we believe it is clear that this transaction served no useful economic purpose. The original transaction between Dresdner Bank, Disko, and the end users was a completed transaction which served the economic and business purposes of all of the parties. Nothing more was needed. Equilease's purchase of the equipment and the subsequent sale to Aardan and petitioner had no effect upon the original transaction between Disko and the end users. In fact, there is no evidence that the end users even knew of the paper shuffling done by Equilease, Aardan, and petitioner. In essence, petitioner claims to have purchased a Christmas tree, but actually only purchased the right to hang some ornaments on a tree that was already in place and serving its full useful and eco-

nomic purpose, and to take possession of the tree after the Christmas holidays.

II. *Other Issues*

Due to our disposition of the economic substance and business purpose issues, we need not reach the issues regarding section 183, section 465, and the appropriate method of depreciation. The only remaining issues for our consideration are whether petitioner's underpayment of tax is attributable to a valuation overstatement within the meaning of section 6659 and whether the transaction was tax motivated within the meaning of section 6621(c) (formerly section 6621(d)).

There is a valuation overstatement for purposes of section 6659 if the adjusted basis of the equipment claimed by petitioner on any return was 150 percent or more of the correct adjusted basis. Section 6659(c). The correct adjusted basis was zero rather than the $3 million claimed by petitioner, so there was a valuation overstatement. The applicable percentage of the underpayment of tax attributable to that valuation overstatement shall be added to the tax. Sec. 6659(a). The applicable percentage is 30 percent. Sec. 6659(b). Accordingly, 30 percent of the underpayment attributable to the valuation overstatement shall be added to petitioner's tax.

Since there is a valuation overstatement under section 6659(c), the transaction was tax motivated within the meaning of section 6621(c)(3). Accordingly, petitioner is liable for the rate of interest established under section 6621(c)(1).

Decision will be entered for the respondent.

COMPUTER EQUIPMENT—FOR HOWARD GILMAN DEC.
LEASED TO EQUILEASE (ALLIED CHEMICAL) FOR
108 MONTHS NON-ITC EQUIPMENT COST: $3,000,000 INDIVI
SUBLEASED TO DISKO (DRESDNER BANK)

	12/31/80	1981	1982	
RENT (1)	1,642	404,400	419,400	7
SALES PROCEEDS (2)				
DEPREC. (3) USED:	(375,000)	(656,250)	(492,187)	(4
INTEREST (4)	(1,641)	(591,000)	(591,000)	(5
DEFERRED INT. 19%		(12,452)	(37,145)	
TAXABLE INCOME (LOSS)	(375,000)	(855,302)	(700,932)	(1
RATIOS (5)	5.882	3.916	3.894	
CASH FLOW (6)				
EQUITY	(45,000)			
NOTE PAYMENTS		(195,000)	(180,000)	
DEFERRAL INT.		(12,452)	(37,145)	
TAX BENEFITS 60%	225,000	513,182	420,560	1
SALES PROCEEDS				
PREFERENCE TAX	(18,750)	(23,437)		
CASH FLOW AT 700/MO.		8,400	8,400	
ANNUAL BENEFIT	161,250	290,691	211,815	1
CUM. BENEFIT	161,250	451,941	663,756	7
TOTAL CUMULATIVE BENEFIT INCL. 5% SINK. FUND (7)(8)	161,250	474,538	720,671	8

(1) ASSUMES CLOSING ON DEC. 31, 1980. RENT FOR STUB MONTH IS $1,641.67
OF LEASE.

(2) TAXPAYER RECEIVES ALL RESIDUAL PROCEEDS LESS 10% REMARKETIN

(3) DEPRECIATION (NON-ITC EQUIPMENT) 6 YEAR LIFE 150% DB IN 1980-1982

(4) RECOURSE MORTGAGE IN FACE AMOUNT OF $2,955,000 BEARING INTERE
APPLIED TO THIS MORTGAGE. INTEREST ONLY THROUGH DEC. 1982.

(5) THE RATIO OF AGGREGATE WRITE-OFFS IN THIS TRANSACTION ($2,373,0

(6) TAXPAYER PAYS EQUILEASE $45,000 ON CLOSING. ON APR. 30, 1981 TAXP
$160,000.00) FOR A TOTAL INVESTMENT OF $420,000 PLUS INTEREST ON TH

(7) ASSUMES A 5% AFTER TAX RETURN ON "USE-OF-MONEY".

(8) INTERNAL RATE OF RETURN COMPUTED USING MULTIPLE INVESTMENT
TERNAL RATE OF RETURN EQUALS * * * [ILLEGIBLE].

31 FISCAL APPENDIX A

DUAL TRANSACTION 27-DEC-80

1983	1984	1985	1986	1987	1988	1989
795,832	795,832	795,832	795,832	795,832	779,832	795,832
						600,000
(421,875)	(421,875)	(421,875)	(210,937)			
(571,954)	(524,681)	(467,035)	(396,743)	(311,030)	(206,512)	(79,063)
(197,998)	(150,724)	(93,079)	188,150	484,801	589,319	1,316,768
118,799	90,435	55,847	(112,890)	(290,880)	(353,591)	(790,060)
					600,000	
8,400	8,400	8,400	8,400	8,400	8,400	8,400
127,199	98,835	64,247	(104,490)	(282,480)	(345,191)	(181,660)
790,955	889,789	954,037	849,547	567,066	221,874	40,213
890,263	1,038,552	1,157,940	1,106,122	864,823	545,613	382,150

. RENT FOR MONTHS 1-12 is $33,700.00.) 13-24 IS $34,950.00) $66,319.32 FOR BALANCE

NG FEE TO EQUILEASE. ASSUMES 20% NET RESIDUAL VALUE.
2) STL IN 1983-1986.
ST AT 20% PER ANNUM. NOTE PAYMENTS OF 0.00, $195,000.00, AND $180,000.00 ARE

037) TO AGGREGATE INVESTMENT ($462,188) is 5.1411.
PAYER PAYS EQUILEASE $195,000.00) ON JAN. 31, 1982 TAXPAYER PAYS EQUILEASE
HE DEFERRED PAYMENTS. ALL PAYMENTS ARE SECURED BY LETTER OF CREDIT.

SINKING FUND METHOD. ASSUMING A SINKING FUND EARNINGS OF 5%. THE IN-

UNITED STATES TAX COURT
Washington, D.C. 20217

Filed April 23, 1990
Docket No. 15585-87

T.C. MEMO. 1990-205

HOWARD GILMAN,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

David N. Bowen, for the petitioner.

Laurence A. Hoch, *Roland Barral*, and *Drita Tonuzi*, for the respondent.

SUPPLEMENTAL MEMORANDUM OPINION

CLAPP, *Judge*: This case is before us on petitioner's Motion to Vacate or Revise Decision filed February 2, 1990. Respondent filed a Notice of Objection on March 9, 1990. All section references are to the Internal Revenue Code for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

On December 28, 1989, we filed our opinion in this case, which is reported at T.C. Memo. 1989-684. We entered a decision for respondent on January 3, 1990. The case involved petitioner's agreement to purchase certain mainframe computer equipment for $3 million on December 31, 1980. Petitioner made a $45,000 down payment on the date of purchase and gave the seller an interest-bearing limited recourse promissory note in the principal amount of

$2,955,000. A portion of the interest payments due in 1981 and 1982 were evidenced by separate short-term promissory notes, which themselves bore interest, due on April 30, 1981, and January 31, 1982. The note due on April 30, 1981, was in the amount of $195,000 with interest of $12,452. We held that petitioner's transaction lacked both business purpose and economic substance, and disallowed all of petitioner's deductions for depreciation and interest. We also held that petitioner was liable for a valuation overstatement under section 6659 because the correct basis of the equipment was zero rather than the $3 million claimed by petitioner. We further held that petitioner was liable for the rate of interest established under section 6621(c)(1).

We first note that the granting of a post-decision motion rests within the discretion of the Court and will not be granted unless unusual circumstances or substantial error is shown. See *Vaughn v. Commissioner*, 87 T.C. 164, 166-167 (1986); *Estate of Bailly v. Commissioner*, 81 T.C. 949, 951 (1983); *Robin Haft Trust v. Commissioner*, 62 T.C. 145 (1974), affd. on this issue 510 F.2d 43, 45 n.1 (1st Cir. 1975). It is the policy of this Court to try all the issues raised in a case in one proceeding to avoid piecemeal and protracted litigation. In the interest of efficient performance of all judicial work, it is well settled that a post-decision motion cannot raise theories or grounds that could have been advanced or supported at the earlier trial. See *Chiquita Mining Co. v. Commissioner*, 148 F.2d 306 (9th Cir. 1945); *Standard Knitting Mills v. Commissioner*, 141 F.2d 195, 198-199 (6th Cir. 1944); *Robin Haft Trust v. Commissioner, supra.* As we noted in *Koufman v. Commissioner*, 69 T.C. 473, 476-477 (1977)—

> This Court has an extraordinarily heavy volume of cases, and in many of them, the Court decides an issue against one of the parties because of his failure to carry his burden of proof or to perform some other act. If the Court granted a second chance to every party who lost because of his failure to act in some manner, the Court clearly could not keep abreast of its work. In effect, we

> would be telling the parties that if they were not satisfied with the first decision, try again. However, on previous occasions, we have denied a petitioner's motion to vacate the decision and reconsider the opinion where the only basis for these motions was the petitioner's unexcused failure to raise certain issues earlier. * * *

In his Motion to Vacate or Revise Decision, petitioner makes two arguments. First, he argues that the facts of the case are such that he should have been allowed a deduction for the $12,452 of interest he paid on the note due on April 30, 1981. He cites *Rose v. Commissioner*, 88 T.C. 386, 423 (1987), affd. 868 F.2d 351 (6th Cir. 1989), in which we stated that "Even if the notes themselves do not give rise to tax deductions because they were payments for anticipated tax benefits, the interest actually paid on those notes is deductible under section 163." *Rose v. Commissioner*, *supra* at 423. Petitioner did not make this argument in his petition, in the trial memorandum, at trial, or on brief. Under these circumstances, we normally would deny petitioner's motion. However, respondent in his Notice of Objection agrees that petitioner is entitled to the $12,452 interest deduction for the 1981 taxable year. This concession by respondent requires that the decision in this case be entered under Rule 155 rather than for respondent. Accordingly, we vacate our original decision and will enter a new decision under Rule 155.

Petitioner's second argument is that we erred in imposing upon him an addition to tax under section 6659. Section 6659 states in relevant part—

> (a) ADDITION TO THE TAX.—If—
>
> (1) an individual * * *
>
> has an underpayment of the tax imposed by chapter 1 for the taxable year which is attributable to a valuation overstatement, then there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributable.

* * *

(c) VALUATION OVERSTATEMENT DEFINED.—

(1) In general.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

Petitioner cites *Todd v. Commissioner*, 89 T.C. 912 (1987), affd. 862 F.2d 540 (5th Cir. 1988), in which depreciation deductions were disallowed because certain overvalued equipment was not placed in service. We held that the underpayment was not "attributable to" a valuation overstatement. *Todd*, however, did not address a situation such as in the instant case where the transaction lacked economic substance. When a transaction lacks economic substance, section 6659 will apply because the correct basis is zero and any basis claimed in excess of that is a valuation overstatement. *Rybak v. Commissioner*, 91 T.C. 524, 566-567 (1988); *Clayden v. Commissioner*, 90 T.C. 656, 677-678 (1988). Accordingly, we reject petitioner's second argument.

An appropriate order will be issued and a decision will be entered under Rule 155.

UNITED STATES TAX COURT
Washington, D.C. 20217

Docket No. 15585-87

HOWARD GILMAN,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ORDER

Pursuant to the determination of the Court as set forth in T.C. Memo. 1990-205 filed April 23, 1990, it is

ORDERED that the Memorandum Findings of Fact and Opinion filed December 28, 1989 (T.C. Memo. 1989-684), is hereby revised by deleting on page 30 the words: "Decision will be entered for the respondent." and inserting in lieu thereof the words: "Decision will be entered under Rule 155."

(Signed) CHARLES E. CLAPP II
Charles E. Clapp II
Judge

Dated: Washington, D.C.
April 23, 1990

UNITED STATES TAX COURT
Washington, D.C. 20217

Docket No. 15585-87

HOWARD GILMAN,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ORDER

On February 2, 1990, petitioner filed a Motion to Vacate or Revision Decision. On March 9, 1990, respondent filed a Notice of Objection accompanied by a Memorandum of Authorities in Support of Respondent's Notice of Objection to Petitioner's Motion to Vacate or Revise Decision. Pursuant to the determination of the Court as set forth in T.C. Memo. 1990-205 filed April 23, 1990, it is

ORDERED that petitioner's Motion to Vacate or Revise Decision is granted in that the decision entered January 3, 1990, is hereby vacated and set aside.

(Signed) CHARLES E. CLAPP II
Charles E. Clapp II
Judge

Dated: Washington, D.C.
April 23, 1990

UNITED STATES TAX COURT
Washington, D.C. 20217

Docket No. 15585-87

HOWARD GILMAN,

Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinion of the Court filed December 28, 1989, the supplemental opinion of the Court filed April 23, 1990, and the settlement of other issues by the parties, and incorporating herein the facts recited in the respondent's computation and the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years 1980 and 1981 in the amounts of $171,680.00 and $320,135.00, respectively;

That there is an addition to the tax due from the petitioner for the taxable year 1981 under the provisions of section 6659 in the amount of $96,040.50; and

That the deficiencies due from the petitioner for the taxable years 1980 and 1981 are each substantial underpayments attributable to tax motivated transactions under the provisions of section 6621(c), formerly section 6621(d).

(Signed) CHARLES E. CLAPP II

Charles E. Clapp II
Judge.

Entered: JUNE 22, 1990

* * * * *

SERVED JUN 22 1990

It is hereby stipulated that the foregoing decision is in accordance with the opinion and supplemental opinion of the Court, and the settlement of certain issues and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

ABRAHAM N. M. SHASHY, JR.
Chief Counsel
Internal Revenue Service

By: (Signed) BERNARD GOLDSTEIN

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Tax Court No. AR0075

June 15, 1990

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

DOCKET NUMBER 90-4127

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 16th day of July, one thousand nine hundred and ninety-one.

HOWARD GILMAN,
Petitioner-Appellant,

—v.—

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by petitioner-appellant, Howard Gilman.

Upon consideration by the panel that heard the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

(Signed) ELAINE B. GOLDSMITH
ELAINE B. GOLDSMITH
Clerk

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

DOCKET NUMBER 90-4127

At a Stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 14th day of May, one thousand nine hundred and ninety-one.

Present: HON. JON O. NEWMAN
HON. FRANK X. ALTIMARI
Circuit Judges,

HON. KENNETH CONBOY
*District Judge**

HOWARD GILMAN,
Petitioner-Appellant,

—v.—

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the United States Tax Court.

This cause came to be heard on the transcript of the record from the United States Tax Court, and was argued by counsel.

* The Honorable Kenneth Conboy, United States District Judge for the Southern District of New York, sitting by designation.

ON CONSIDERATION WHEREOF, it is now hereby ORDERED, ADJUDGED and DECREED that the ORDER of said Tax Court be and it hereby is affirmed in accordance with the opinion of this court with costs to be taxed against the appellant.

Elaine B. Goldsmith, Clerk
By:

(signed) EDWARD J. GUARDARO
Edward J. Guardaro
Deputy Clerk

A TRUE COPY
ELAINE B. GOLDSMITH

(Signed) ELAINE B. GOLDSMITH
Clerk

§ 1.183-2 Activity not engaged in for profit defined.—(a) *In general.* For purposes of section 183 and the regulations thereunder, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212. Deductions are allowable under section 162 for expenses of carrying on activities which constitute a trade or business of the taxpayer and under section 212 for expenses incurred in connection with activities engaged in for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Except as provided in section 183 and Sec. 1.183-1, no deductions are allowable for expenses incurred in connection with activities which are not engaged in for profit. Thus, for example, deductions are not allowable under section 162 or 212 for activities which are carried on primarily as a sport, hobby, or for recreation. The determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. In determining whether such an objective exists, it may be sufficient that there is a small chance of making a large profit. Thus it may be found that an investor in a wildcat oil well who incurs very substantial expenditures is in the venture for profit even though the expectation of a profit might be considered unreasonable. In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

(b) *Relevant factors.* In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or

that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) *Manner in which the taxpayer carries on the activity.* The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

(2) *The expertise of the taxpayer or his advisors.* Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

(3) *The time and effort expended by the taxpayer in carrying on the activity.* The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity

does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

(4) *Expectation that assets used in activity may appreciate in value.* The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of Sec. 1.183-1 for definition of an activity in this connection.

(5) *The success of the taxpayer in carrying on other similar or dissimilar activities.* The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

(6) *The taxpayer's history of income or losses with respect to the activity.* A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

(7) *The amount of occasional profits, if any, which are earned.* The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

(8) *The financial status of the taxpayer.* The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.

(9) *Elements of personal pleasure or recreation.* The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than

solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). The taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so. The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each year. The decedent from whom the taxpayer inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings which yield large income from dividends. The taxpayer lives on an area of the farm which is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The taxpayer's activity of farming, based on all the facts and circumstances, could be found not to be engaged in for profit.

Example (2). The taxpayer is a wealthy individual who is greatly interested in philosophy. During the past 30 years he has written and published at his own expense several pamphlets, and he has engaged in extensive lecturing activity, advocating and disseminating his ideas. He has made a profit from these activities in only occasional years, and the profits in those years were small in relation to the amounts of the losses in all other years. The taxpayer has very sizable income from securities (dividends and capital gains) which constitutes the principal source of his livelihood. The activity of lecturing, publishing pamphlets, and disseminating his ideas is not an activity engaged in by the taxpayer for profit.

Example (3). The taxpayer, very successful in the business of retailing soft drinks, raises dogs and horses. He began

raising a particular breed of dogs many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since. The taxpayer recently began raising and racing thoroughbred horses. The losses from the taxpayer's dog and horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years. The taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently. The taxpayer races his horses only at the "prestige" tracks at which he combines his racing activities with social and recreational activities. The horse and dog operations are conducted at a large residential property on which the taxpayer also lives, which includes substantial living quarters and attractive recreational facilities for the taxpayer and his family. Since (i) the activity of raising dogs and horses and racing the horses is of a sporting and recreational nature, (ii) the taxpayer has substantial income from his business activities of retailing soft drinks, (iii) the horse and dog operations are not conducted in a businesslike manner, and (iv) such operations have a continuous record of losses, it could be determined that the horse and dog activities of the taxpayer are not engaged in for profit.

Example (4). The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died. The taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately $8,500 per year. The farm has not been profitable for the past 15 years because of rising costs of operating farms in general, and because of the decline in the price of the produce of this farm in particular. The taxpayer consults the local agent of the State agricultural service from time to time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the

area, are operated. Many of these other farms do not make profits. The taxpayer does much of the required labor around the farm himself, such as fixing fences, planting crops, etc. The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the taxpayer for profit.

Example (5). A, an independent oil and gas operator, frequently engages in the activity of searching for oil on undeveloped and unexplored land which is not near proven fields. He does so in a manner substantially similar to that of others who engage in the same activity. The chances, based on the experience of A and others who engaged in this activity, are strong that A will not find a commercially profitable oil deposit when he drills on land not established geologically to be proven oil bearing land. However, on the rare occasions that these activities do result in discovering a well, the operator generally realizes a very large return from such activity. Thus, there is a small chance that A will make a large profit from his soil exploration activity. Under these circumstances, A is engaged in the activity of oil drilling for profit.

Example (6). C, a chemist, is employed by a large chemical company and is engaged in a wide variety of basic research projects for his employer. Although he does no work for his employer with respect to the development of new plastics, he has always been interested in such development and has outfitted a workshop in his home at his own expense which he uses to experiment in the field. He has patented several developments at his own expense but as yet has realized no income from his inventions or from such patents. C conducts his research on a regular, systematic basis, incurs fees to secure consultation on his projects from time to time, and makes extensive efforts to "market" his developments. C has devoted substantial time and expense in an effort to develop a plastic sufficiently hard, durable, and malleable that it could be used in lieu of sheet steel in many major applications, such as automobile bodies. Although there may be only a small chance that C will invent new plastics, the return from any such development would be so large that it induces

C to incur the costs of his experimental work. C is sufficiently qualified by his background that there is some reasonable basis for his experimental activities. C's experimental work does not involve substantial personal or recreational aspects and is conducted in an effort to find practical applications for his work. Under these circumstances, C may be found to be engaged in the experimental activities for profit.